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, January 14, 1969, at 9:30 a.m.

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

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

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

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

Messrs. Coyne and Nichols, Special Assistants to the Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors

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

Messrs. Eisenmenger, Eastburn, Snellings, 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. Meek, 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 December 17, 1968, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on December 17, 1968, was accepted.

The reports of audit of the System Open Market Account and of foreign currency transactions, made by the Board's Division of Federal Reserve Bank Operations as at the close of business on October 18, 1968, and submitted by Mr. Schaeffer, Chief Federal Reserve Examiner, were accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market

Account and Treasury operations in foreign currencies for the period December 17, 1968, through January 8, 1969, and a supplemental report covering the period January 9 through 13, 1969. 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 was unchanged again this week. The Bank of Italy had taken $76 million of gold last week and the Swiss wanted $50 million, but there were no other orders in sight and the Stabilization Fund still had a balance of $450 million on hand.

On the London gold market, Mr. Coombs continued, the price was up again this morning, to $42.40. The recent increases reflected the continuing uncertainty over U.S. gold policy, Middle East tensions, and the progressive erosion of the overhang that had resulted from last winter's official gold sales. He expected further trouble from the gold market in the months to come.

On the exchange markets, Mr. Coombs observed, sterling had failed to show any improvement despite the fact that seasonally favorable influences generally produced inflows to Britain at this time of year. The recent squeeze in the Euro-dollar market had been a handicap in that it increased the disadvantage against sterling, and the Bank of England might have to take some action to improve that relationship. However, the basic difficulty lay in Britain's foreign trade balance. Figures just released this morning showed that Britain had had a trade deficit of 55 million pounds in December, as compared with 17 million pounds in November. Market confidence in sterling remained at a low ebb, and, as he had said on earlier occasions, he shared the market's view that the present $2.40 parity might well prove untenable. He was afraid that most of the European central bankers felt the same way. In his judgment, in the event of a new sterling crisis it probably would not be possible for Britain to obtain new credits from those European central banks that held substantial reserves.

In effect, Mr. Coombs said, the devaluation of November 1967 had proved to be a failure. In the period of just over a year since devaluation, the Bank of England had had to take additional credits of $3.4 billion--more than ever before in a comparable period--with the result that Britain's external debt burden had approached the point of unmanageability. While some progress in restructuring the debt had been made last summer, heavy instalment payments on the British debt to the International Monetary Fund and to others would fall due this year. Unless the scheduled payments to the Fund were deferred until next year or later, the British might well be drawing on their swap line with the System to pay the Fund. That, in his judgment, would be a travesty. He gathered that the Fund was prepared to accept some postponement of its claims and he hoped that the incoming officials of the U.S. Treasury would press for early action on that matter. Meanwhile, the Bank of England still had available a little more than $200 million under existing credit lines with European central banks. He had suggested that they might use those lines before drawing further on the System.

Mr. Coombs remarked that the French franc had been stabilized temporarily by unusually severe exchange controls, but the state of market confidence was well reflected in discounts on forward francs of 9 or 10 per cent. The French trade figures for December showed a further deterioration from the already poor figures for November and wage negotiations scheduled for March were expected to cause further dangerous strains. The general view of the European central bankers was that the French Government had succeeded only in postponing the inevitable.

Mr. Coombs observed that the only bright spot in recent exchange market developments had been the outflow of money from Germany, the volume of which had been astonishing. From the date of the Bonn meeting through the end of December the net outflow had very nearly equaled the massive inflow during the first three weeks of November. Another $1 billion had moved out of Germany since the turn of the year, providing a much-needed offset against the heavy demand for Euro-dollars by U.S. banks. How long the outflow would continue was problematical. The German economy was moving toward full capacity now, and if wage and price pressures developed the German Federal Bank might conclude that it could no longer maintain its present easy money posture.

Moreover, German Government officials continued to hint at revaluation. Mr. Schiller kept referring to the need for realignment of currency parities, and as the Committee members might have noted, Dr. Blessing recently acknowledged publicly that the German Federal Bank had recommended a revaluation of the mark at the time of the Bonn conference.

At the Basle meeting during the past weekend, Mr. Coombs continued, some individual central bankers had expressed concern about the impact on their money markets of the recent credit tightening in the United States. However, there was a general feeling that the Federal Reserve's actions had been essential to break the wave of inflationary psychology that was prevalent not just in the United States but world-wide.

Much of the discussion at the Basle meeting, Mr. Coombs said, was concerned with the subject of "recycling" speculative flows that had first been broached in November and had subsequently been considered in several meetings of technical advisers. Three main approaches were suggested of which the first, proposed by Governor Carli of the Bank of Italy, would involve a fully automatic, open-end arrangement under which flows of speculative funds would be rechanneled back by the central bank of the recipient country. That approach was flatly rejected by all of the others, and even the Italians finally backed away from it. The second suggestion was advanced by the Belgians, who in the past had not been overly sympathetic to the System's swap network. It involved a grandiose plan for an intra-European swap network, in which each central bank would have swap lines with all others. The Belgian plan would have led to large-scale pyramiding of commitments and was unanimously rejected as simply unworkable. The third suggestion had been advanced partly at the instance of the U.S. representatives at the meeting. It called for a system of voluntary deposits in the Bank for International Settlements by central banks of countries receiving speculative flows. Those deposits would then be relent to the central bank of the country losing funds, with a collective guarantee on the loans by all participating central banks. That proposal also met with objections, mainly on the matter of guarantees; few of the central bankers present thought they had legal authority to provide such guarantees. The fact that acts of parliament would be needed in a number of countries appeared to present an insurmountable obstacle to early--and perhaps even eventual--implementation of such a plan.

Mr. Coombs noted that the governors of only two central banks--O'Brien of England and Brunet of France--expressed any real sympathy for going beyond the credit arrangements already in place, which consisted of the Federal Reserve swap network and various ad hoc arrangements. Mr. Hayes and he (Mr. Coombs) felt that something had to be done in response to the statement in the Bonn communique that a study would be made of means for alleviating the impact on reserves of speculative movements. In an effort to break the impasse at Basle they had suggested a fourth approach involving a single swap network. In effect, each participating central bank would extend a credit line to the BIS, thus providing a pool of reserves that could be made available to a central bank experiencing a speculative outflow. Such an arrangement, in itself, would not be adequate to deal with a situation in which the inflows of hot money were concentrated in a single central bank; for example, if only the German Federal Bank were experiencing inflows, other central banks might have insufficient funds to support credits to the countries losing funds and the Germans presumably would be unwilling to bear the entire credit risk. Accordingly, the plan had a second element under which the central bank gaining reserves would rediscount credits extended by others to central banks losing reserves. For example, if there were a speculative flow from France to Germany, the Netherlands might participate in extending credits to France through the BIS, raising the funds by rediscounting the credits with the Germans. In effect, Germany would still be providing the funds to France but their risk exposure would be minimized since the paper would bear the names of the central banks of both France and the Netherlands. While there was more hope for that proposal than for the other three, he could not say whether it would be considered acceptable. In light of the statement in the Bonn communique, the market was likely to construe a failure of a recycling plan to emerge as a breakdown in international cooperation.

Finally, Mr. Coombs said, he might refer briefly to the question Mr. Maisel had raised at the previous meeting of the Committee relating to possible conflicts between the System's foreign currency operations and domestic credit policy. He (Mr. Coombs) thought that Mr. MacLaury had given an excellent response at the meeting. In addition, Mr. MacLaury currently was preparing a memorandum on the subject that Mr. Coombs thought would relieve any apprehensions in that area that the members might have. As that memorandum would indicate, operations of the types Mr. Maisel had referred to had been undertaken only at times, such as year-ends, when the domestic Desk was also operating in the same direction. In general, such foreign currency transactions had in no way impeded domestic operations.

Mr. Daane asked whether there had been any evidence of restiveness with respect to the gold situation at the Basle meeting.

Mr. Coombs replied that there had been a great deal of restiveness on that subject in Basle. The European central bankers were being subjected to questions at home as to whether any change in U.S. gold policy was likely and whether their countries were adequately protected in the event of such a change. It was their hope that the new Administration would make a forthright statement on gold soon.

By unanimous vote, the System open market transactions in foreign currencies during the period December 17, 1968, through January 13, 1969, were approved, ratified, and confirmed.

Mr. Coombs reported that three drawings by the System on the Swiss National Bank would reach the end of their current three-month terms soon. They included drawings of $50 million and $30 million which would mature for the first time on January 28 and February 4, 1969, respectively; and a drawing of $40 million, which would mature for the second time on January 31. The System had a total of $320 million in drawings outstanding on the Swiss National Bank, and he had talked with the Swiss officials during the weekend about possible arrangements to permit the System to repay soon an amount on the order of $200 million. Any such arrangements probably would include the issuance of a Swiss franc-denominated bond by the U.S. Treasury as a major component. If those arrangements were completed it might prove possible to repay the three drawings in question before their maturity dates. Otherwise, however, he would recommend their renewal for further periods of three months.

Renewal of the three drawings on the Swiss National Bank was noted without objection.

Mr. Coombs then reported that two drawings on the Federal Reserve by the Bank of France would mature on February 13, 1969. One, of $15 million, would be reaching the end of its first three-month term then; the other, of $50 million, already had been renewed once. As the Committee knew, the Bank of France had made a fair amount of progress in paying down its swap debt to the System over the past month. However, they had managed to do so by using the exhaustible resource of dollars held by their commercial banks and citizens. He would recommend renewal of the two drawings in question if the French were unable to repay them at maturity.

In reply to a question by Mr. Mitchell, Mr. Coombs said that many drawings by the System and by other parties under the swap lines had remained outstanding for periods of six to nine months, and some had remained on the books for longer periods. It was his recollection that only a few had been outstanding for slightly more than a year.

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

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 December 17, 1968, through January 8, 1969, and a supplemental report covering January 9 through 13, 1969. Copies of both reports have been placed in the files of the Committee.

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

> As the written reports to the Committee indicate, the financial markets reacted vigorously to the tightening of monetary policy voted by the Committee at the last meeting. Most observers have interpreted the System moves as a determined drive against the forces of inflation. Currently, a debate is raging as to whether the markets and the banking system face a lengthy period of sustained pressure or a shorter period of intense pressure that soon will be

reversed if and as the economy cools off. In this atmosphere, I fear the System faces the delicate task of letting the markets settle down after having weathered the turbulence of year-end, while avoiding any impression that we are loosening up on the policy reins. Interest rate levels reached just before Christmas were probably too high--if sustained--to avoid an overly severe squeeze on bank CD's with attendant problems in all financial markets. Current rate levels are more consistent with a manageable degree of pressure on the banks, provided that the banks are not overwhelmed by a precautionary wave of borrowing by business firms. Indications that a major part of the money repatriated from abroad by U.S. firms at the year-end may be used at home provides at least a glimmer of hope on that score.

Interest rates in all maturity areas quickly rose to new record highs following the System's discount rate and open market actions and the increase in the prime rate, reaching their peaks just before Christmas. Since then rates have tended to move lower, with a temporary reversal of the movement when the prime rate was raised once again on January 7. The three-month Treasury bill rate--which touched a peak of 6.29 per cent on December 24--closed last night at 6.13 per cent, after broad-based demand at the new rate levels before and after the year-end had brought dealer positions down sharply. Trading volume reached an all-time high during the period, straining the facilities of the clearing banks and causing for the first time some concern about fail problems in the Government market. In yesterday's regular Treasury bill auction average rates of 6.21 and 6.37 per cent were established respectively for three- and six-month Treasury bills, up about 1/4 and 3/8 percentage points from the rates established in the auction just preceding the last Committee meeting.

Yields on intermediate- and long-term Government securities followed roughly the same pattern as Treasury bill rates--rising precipitously before Christmas and declining thereafter--although there was a sharp reaction to the January 7 prime rate increase. The willingness of dealers to cut prices, despite the capital losses involved, permitted sustained market activity, with dealer positions in coupon issues of over 1-year maturity declining by $347 million since December 16 to $117 million by the close of business last Friday. The market is thus getting into a good technical position for the forthcoming Treasury refunding, although whether much enthusiasm can be generated remains to be seen. Dealers have been generally hard hit by the price movements of the last six weeks, but have been sustained by the hope that a successful drive against inflation will mean better days for the bond market in the months ahead.

Open market operations over the period were directed first at moving decisively to firmer money market conditions and then at maintaining pressure while trying to prevent interest rates from going through the roof. It was of considerable importance, we felt, to signal to the market early that the change in the discount rate was more than a technical reaction to the already prevalent increases in market rates. Thus, on the first day of the new statement week following the last Committee meeting, with projections indicating a possible need to absorb reserves, the System sold Treasury bills in a market go-around despite a somewhat shaky atmosphere in the market. Although a total of only $187 million of bills was sold the market got the message immediately. No further outright sales were made in the market until last Friday, although substantial sales on balance for foreign account tended to put pressure on the market from time to time. For much of the period, of course, the System was meeting seasonal reserve needs. Outright purchases amounted to $518 million in the market and to nearly $800 million from foreign accounts, while repurchase agreements were used quite extensively.

Bank reaction to the tightening of monetary policy was, of course, exacerbated by the usual year-end turbulance which was strengthened by the fact that holidays fell on the final day of the last two statement weeks of the year. Banks therefore tended to manage their reserve positions cautiously. Money market banks bid aggressively for Federal funds early in the statement week--pushing rates into new high ground and accumulating more reserves than they really needed to meet their requirements. Thus, both borrowings and excess reserves were unusually high in the statement weeks ending December 25 and January 1, with the Federal funds rate easing off on the final day of each of the last three statement weeks. Looking to the future, I have little to add to the discussion of prospective developments in the blue book.[1/] I suspect that money center banks will make every effort to avoid the capital losses involved in major adjustments of their investment portfolios by bidding aggressively for Federal funds, Euro-dollars, and foreign official time deposits. Last week there was some evidence that some of the non-money market banks, who are the providers of Federal funds, were being lured by attractive rates into Treasury bills and other investments. If this development should proceed very far, the Federal funds rate could settle at or above the upper end of the range suggested in the blue book as being consistent with an unchanged stance for monetary policy. The Euro-dollar market has also felt the impact of the tighter situation--rates there rose to 8 per cent or more on up to three-month maturities as the major banks built their holdings back to mid-December levels after the seasonal decline at year-end. Euro-dollar rates normally decline in January; they have recently come off their peaks but it is probably too early to predict developments there with any certainty. As far as foreign official deposits are concerned, New York banks have paid as much as 7-1/2 per cent for one-month money and 7-1/4 per cent for three-month money, far above the Q ceiling for private deposits.

Basically, it seems to me, we are in a race between a seasonal slackening of pressure on interest rates and a counter-seasonal pressure on bank CD's arising from the relation of market rates to the Q ceiling. The outcome cannot be predicted with confidence and we may have to put up with substantial variations in rate and reserve relationships from those that seem most likely at the present time.

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

As you know, the Treasury is auctioning today $1-3/4 billion of June tax bills, with banks permitted to pay for their bills through credit to tax and loan accounts. The banks were rather disappointed with the meager value of the tax and loan account privilege at the last auction of tax bills and are approaching the new auction with some caution. Nevertheless, given the better technical position of the bill market, adequate bank bidding is anticipated and the market, which expects to have to take on a large proportion of the bills awarded to banks over a short period, seems to be taking the auction in stride. As the blue book notes, the Treasury may still need $1-1/2 to $2 billion of new money by early March. Whether or not a major part of this amount can be raised in conjunction with the February 15 refunding remains to be seen. The refunding, which should be announced on about January 29, involves a total of $14-1/2 billion of maturing issues, of which $5.4 billion are held by the public. Banks hold a rather large percentage of the public holdings, and there may be a tendency for some of the larger banks to let their holdings run off as part of their current portfolio adjustment program. At current yield levels the Treasury will have to offer an attractive coupon--perhaps 6-3/8 to 6-5/8 per cent, depending on maturity. And this in turn may create new problems of disintermediation for the banks and thrift institutions. The new Treasury debt management team, whoever they may be, will thus be faced with major decisions in their first ten days in office.

The System holds $1,140 million of the maturing 4 per cent bonds and $7,441 million of the maturing 5-5/8 per cent notes. It would appear likely--given the size of the public holdings--that the Treasury might decide to offer a short-term and a somewhat longer-term note. In that event I would plan to distribute the System's subscriptions between the two issues in accordance with the amounts offered to the public if it is a cash exchange, or in accordance with expected public subscriptions if the Treasury decides on a rights exchange.

Mr. Mitchell commented that growth in various aggregate monetary measures--bank time deposits, the narrowly defined money supply, and the bank credit proxy--had been disappointingly large in December for reasons that were not wholly clear to him. He noted, however, that the staff projected a decline in time deposits and only a small increase in the credit proxy in January. He wondered if the Manager thought these projections were likely to be realized, given the present posture of monetary policy, and how long credit markets would be able to sustain the current degree of restraint.

Mr. Holmes replied that under the current interest rate relationships the annual rate of bank credit growth in January might well be reduced to a figure in the neighborhood of 2 per cent, as projected in the blue book. He thought, however, that the impact of such slower growth was likely to be tempered for a while by the fact that expansion in bank credit had been rapid before the year-end and also by the fact that growth of total credit probably was not being curtailed as sharply as that of bank credit.

In response to further questions by Messrs. Mitchell and Hickman, Mr. Holmes indicated that he found it difficult to explain short-run movements in the money supply. He did not think that the relatively rapid growth projected for January--an annual rate of 7 to 10 per cent--was related to changes in Treasury cash balances at commercial banks; it was his recollection that those balances were expected to increase somewhat on average from their December level.

Mr. Keir confirmed that Treasury cash balances were projected to rise slightly in January from their average December level. The relatively high growth rate projected for the money supply in January resulted from a bulge in demand deposits around the year-end. That bulge served to augment the average level of the money supply for January as a whole even though sizable declines in money balances were projected to occur over the course of the month. He added that he could offer no plausible explanation for the rapid expansion in money supply at the year-end beyond the tentative reasons given in the blue book.[1/]

Mr. Bopp remarked that he found it difficult to understand one of the explanations for the year-end bulge in the money supply. He did not see how payments by corporations into their pension funds could occasion a change in demand deposits for the banking system as a whole.

Mr. Keir said the staff presumed that holdings of temporary cash balances had risen sharply around year-end partly because investors holding liquidity balances earmarked for payment of commitments on long-term investments were unwilling to invest those balances temporarily in short-term assets at a time when the risk of further sharp increases in short-term rates appeared to be high. In the case of payments by corporations to their pension funds, an increase in idle

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1/ The blue book passage referred to by Mr. Keir read as follows: "No obvious explanation is at hand for the very recent money supply growth, although it is possible that large transfers around year-end--e.g., corporate payments to pension funds, repatriation of liquid funds from abroad, and churning associated with switches from CD's to market securities--may have led to some temporary accumulations of cash in a period of uncertainty."

cash balances could result because such funds were typically managed by a separate trustee and the parent corporation usually had to sell short-term securities from its own portfolio in order to allocate funds--in the form of cash--to the trustee.

In answer to a question by Mr. Heflin, Mr. Holmes indicated that while the prospective CD run-off in January would depend importantly on the course of interest rates, he thought that under prevailing market conditions CD losses could be as high as $2 billion in January. He would expect the losses to continue largest at major New York banks.

Mr. Daane asked Mr. Holmes whether the market seemed convinced of the System's determination to carry forward its policy of restraint or whether the skepticism reported in some market letters was widespread.

Mr. Holmes replied that opinions on the matter were divided. Some market participants were convinced that System policy would continue on its present course, while others thought it likely that signs of cooling in the economy would be followed by some reduction in the present degree of restraint. The market was watching the System's actions closely for clues about the future direction of policy.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period December 17, 1968, through January 13, 1969, 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. Wernick made the following statement concerning economic developments:

> Recent thinking, which has emphasized the undiminished upward momentum of the economy, may now have to face up to the possibility of a change in the course of economic events. Since the last meeting of the Committee, there have been two significant developments which could well alter businessmen's spending decisions. First, the recent turn to tighter money markets has revived memories of the 1966 credit crunch and its aftermath of slow economic growth and reduced profit margins. Second, the apparent recent weakness in retail sales does not support the much publicized notion that the affluent consumer will continue to spend freely regardless of fiscal or other restraints. In fact, the spurt in consumer spending after midyear, following the passage of the tax surcharge, now appears to have been relatively short-lived. While some of the loss of sales at year-end--retail sales fell 2 per cent in December--must be credited to the flu and erratic statistics, slackening nevertheless seems to have begun much earlier in the fall.
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> In retrospect, anticipatory buying on the part of consumers last summer appears to have been limited mainly to the purchase of 1968-model cars prior to the introduction of the higher priced new models. Not long after the new models were introduced, automobile sales began to edge off; they were down to an 8.5 million rate in December compared to over 9 million in September and October, and early January sales were not strong. Nondurable goods sales were not much above midsummer levels even before the slide-off in December.
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> The official GNP estimates made available today, therefore, indicate that the rise in consumer expenditures slowed dramatically in the fourth quarter to about $5 billion compared with more than $13 billion in the third quarter.

In contrast to the caution in spending now being indicated by the consumer, business optimism continues strong. In December the production index rose another one per cent, employment advanced rapidly, unemployment remained at the 15-year low of 3.3 per cent, and industrial price increases were widespread.

And for the fourth quarter as a whole, a sharper rise than anticipated in fixed investment expenditures and a rapid step-up in inventory accumulation helped to sustain current-dollar GNP growth at almost the previous quarter's rate. But with the price deflator accelerating, the annual rate of real growth declined significantly in the fourth quarter to a 3.7 per cent rate, well below the average of over 6 per cent in the first half of the year and a 5 per cent rate in the third quarter.

Probably of most significance for the short-run outlook has been the latent weakness in the economy inherent in the sharp run-up in inventories starting in late summer. Based mainly on October-November data, inventory accumulation is estimated to have been at an annual rate of $10 billion, on a GNP basis, a faster pace of stockpiling than in the previous quarter despite continued liquidation of steel stocks and a leveling off in defense inventory growth. Moreover, the easing of retail sales and the further large increase in industrial production in December suggest that the final figures for inventory accumulation for the fourth quarter as a whole could be even larger than the present Commerce estimate. Thus, with stocks rising more rapidly than sales, the stock-sales ratio for business inventories as a whole at year-end was probably only slightly less than it had been two years earlier, just prior to the large inventory adjustment of 1967.

Looking to the future, it seems highly doubtful that the recent rate of growth can long be sustained if it stems primarily from excessive inventory accumulation and rising investment expenditures in the face of the increasing number of factors acting to limit over-all demands. Slower growth in consumer spending has apparently now been added to the leveling in Federal Government expenditures as a source of reduced stimulus in the economy. The Federal Budget will be moving strongly into a large surplus in the second quarter. Market interest rates have moved up sharply and reduced availability of funds should begin, with a moderate lag, to curb construction activity.

It is possible that consumer expenditure growth could rebound somewhat in the next month or two, given the special factors lowering December sales and the volatile movements that have come to be expected in this series. But there is little evidence pointing to any sustained resurgence. The impact of the increase in social security taxes and retroactive 1968 tax payments on disposable income is a major consideration. Moreover, special influences which sparked unusually large income gains in 1968, such as the large minimum wage increase, substantial hikes in social security benefits, and extensive front-loading of first-year labor contracts, should be less significant counters to income restraints this year. And given further rapid consumer price increases, real after-tax wage gains will at best be minimal this year. In any event, consumers will have to reduce their saving rate further to maintain even the moderate rate of growth in their spending we have assumed in our projections.

On the other hand, expenditures for plant and equipment will probably continue at a rapid pace. Stepped-up spending plans are unlikely to be quickly reduced or abandoned as long as costs are rising and businessmen hold to their longer-run fears concerning inflation. Changes in investment outlays also tend to lag other sectors; in the past they often have continued to rise fairly rapidly even after over-all economic expansion had moderated considerably. However, with the relatively high inventory overhang, business efforts to stem a growing imbalance between output and consumption may become necessary before the quarter is over and industrial production could begin to level off. Without the thrust from inventory building we experienced last quarter, GNP growth would moderate further this quarter.

By next quarter, the underlying factors slowing final demands in the economy seem likely to become more pervasive as stock building continues to ease and the impact of credit restraint begins to limit construction activity. However, with pressure on industrial prices still likely to be widespread, and inflation continuing to be important in business investment and spending decisions, it seems unlikely that the rate of price rise will moderate significantly so soon.

But if we make headway in moderating rates of expansion in real growth to perhaps a 1-1/2 to 2 per cent rate in the second quarter, pressure on resources and prices should begin to ease somewhat and the rise in the price deflator could be reduced to about a 3-1/2 per cent rate before midyear. Since costs would still be under upward pressures--at least from decelerating productivity if not from accelerating wages--further progress would probably require maintaining the surcharge and other constraints on demands for a longer period of time. But an evaluation of the second half of the year will have to wait until the next meeting, when we have had a chance to assess the new Federal Budget, which we will receive in the next day or two.

In summary then, it appears that the real growth in the economy has begun to moderate and that prospects for slowing demands appreciably further before midyear seem more realizable now than earlier. But at the same time, the prospects for a gradual slowing in the pace of economic growth which we have projected could be threatened by persistent business expectations of further inflation and their spending decisions based on these expectations. Continued restraint in both monetary and fiscal policy would seem to be called for in the present situation to maintain pressure on demands in order to dampen unwanted excesses.

Mr. Keir made the following statement regarding financial developments:

The shift to a tighter monetary policy since the last meeting of the Committee has pushed the CD accounts of major money market banks well beyond the point of disintermediation. Consequently, a sharp cut-back in bank credit growth is now under way. With sizable further CD attrition generally anticipated during the rest of January and February, the principal financial question facing the Committee this morning is whether a policy of maintaining the tighter money and credit market conditions now prevailing would risk a credit crunch--assuming no change in CD rate ceilings.

The evidence available on CD attrition through early January indicates that the run-off thus far has been heavily centered on the relatively small number of major money market banks that typically finance a sizable part of their reserve needs in markets for interest-sensitive funds, here and abroad. Smaller banks, that have less ready access to Euro-dollars and concentrate more on CD sales to less interest-sensitive regional customers, have not as yet been subjected to very severe reserve drains.

Even so, CD run-off in December totaled about $1.5 billion and the estimate for January is roughly the same. Since banks usually add to outstanding CD's in January, this estimate is equivalent to about a $2 billion run-off, seasonally adjusted, or three times the comparable figure for December. This suggests that reserve pressures from CD attrition will cumulate further as January progresses, unless yields on competing market securities decline or Euro-dollars can be reasonably obtained to provide an offset.

Most recently, yields on U.S. Government securities have receded somewhat from their earlier record highs. To some extent this has reflected special demands for short-term securities--in part from the proceeds of maturing CD's--at a time when dealers' positions have been quite low. But the yield declines also seem to have reflected a more fundamental change in market judgment about the likely outcome of the CD squeeze.

Apparently, the relative absence of stepped-up bank security liquidation has encouraged some market participants to believe that major banks can avoid large security sales, at least for the time being, and continue to cover the bulk of their CD run-off through short-term borrowing from other sources. This judgment has probably been reinforced by reports that the prime rate action and some other credit rationing measures are now tending to limit business loan volume. Moreover, while some banks have reportedly become a bit restive because seasonal business loan repayments have been sluggish, the general impression received by the market is that there is as yet little evidence of strong new pressures from would-be corporate borrowers. There is a general attitude of caution at banks regarding the sizable volume of binding loan commitments that have been made to good customers. But to some extent even these are read as a moderating influence that may tend to keep corporate customers from feeling compelled to anticipate future financing needs by actually drawing on their credit lines.

This generally more relaxed market appraisal of the chances for a credit crunch may, of course, be too relaxed, since it seems to assume that all the pieces of the puzzle will fall rather neatly into a reasonable equilibrium. One major roadblock that could upset this equilibrium is the large volume of Treasury borrowing operations due in the market over the next few weeks.

As Mr. Holmes has noted, after today's tax-bill financing the Treasury must refinance sizable public holdings of its maturing February securities and in addition raise perhaps another $1.5 to $2 billion of new money by early March. Since the banking system is already under general pressure from CD attrition, large banks are not likely to hold their underwriting acquisitions of tax bills very long. Likewise, their participation in the refinancing will very likely be minimal, unless market expectations should suddenly change. With bank interest limited, the new Treasury issues will have to be priced to attract larger than usual participation by the non-bank public, a requirement which past experience has shown often leads to higher yields. This would be particularly so if dealers, in the face of continued high financing costs, should become reluctant underwriters. On the other hand, the extent of any yield advance in the Treasury financing period should be limited by the prospect of $10.5 billion of net Federal debt repayment starting in late March and running through June.

Outside the market for U.S. Treasury securities, the weight of CD attrition tends to center on the market for municipal securities, where the forward calendar of new offerings remains heavy. Experience with recent municipal issues suggests that prevailing yield levels may not yet be high enough in this market to overcome the withdrawal of bank participation and attract needed funds from other types of investors. Further strains may, therefore, be in the offing for this market as well. In corporate bond and stock markets, on the other hand, where bank portfolio operations are not a factor, recent changes in quotations seem to reflect some moderation of inflationary expectations, brought on by the combination of tighter money and the economic evidence reported by Mr. Wernick.

Thus far, my comments have focused on CD attrition at major banks, where the bulk of the credit squeeze has been occurring. Partial data indicate that flows to other bank time and savings deposits have also slowed appreciably during the January reinvestment period. And net flows to non-bank depositary-type institutions have weakened significantly during this period too. For the most part these changes in other savings flows appear to have been about in line with industry expectations. Consequently, although the slowing does represent some added constraint on funds available for housing, the industry seems to be taking the change in stride, and there appears to be little risk of an immediate abrupt curtailment of mortgage commitments like the one that occurred in the spring of 1966.

This brief run-down of the cross-currents now present in financial markets suggests that the forces that will determine the actual outcome for interest rates, CD's, and bank credit over the next few weeks are rather sensitively balanced. For this reason, the outcome can be significantly influenced by any emerging news that affects market expectations about the economic outlook, including the full details of the imminent budget and tax proposals. This suggests that a fairly wide range of possible outcomes could emerge on CD's, creating possibilities for significant deviation on either side from the blue-book forecast of a 0 to 3 per cent annual rate of growth in the credit proxy in January.

Given this rather delicate balance of market forces, and the developing evidence that credit restraint is already taking hold, there would seem to be no need for the Committee to move toward further restraint at this time. Indeed, because the market is unusually sensitive to indicators of System policy, particularly the Federal funds rate, it may be important to guard against any unexpected sustained upward pressure on that rate. Such a change could trigger market fears of worse disintermediation to come.

In short, it seems to me that the appropriate decision for the Committee today is to adopt the draft directive submitted by the staff.[1/] If the associated money market and reserve targets specified in the blue book are then effectively realized, the odds of avoiding a credit crunch in the weeks immediately ahead seem quite good--even without a change in CD rate ceilings. The institutions being most severely affected by the CD squeeze are those possessing the greatest resources and know-how for making needed reserve

1/ Appended to this memorandum as Attachemnt A.

adjustments. However, this approach does put a special premium on retaining the two-way bank credit proviso in order to give the Account Manager leeway to respond to possible deviations on either side of the credit proxy projection.

Mr. Solomon said he would preface his prepared statement on balance of payments developments with a few observations on the British trade figures for December, the details of which he had just received. As Mr. Coombs had indicated, Britain's foreign trade position had worsened in December following a sharp improvement in November. However, it probably was not reasonable to expect that all of the November improvement would be retained. Moreover, the worsening in December was due to a decline in exports; imports, which had been the main source of difficulty all along, also declined slightly. While the recent trade figures did not offer grounds for cheery optimism, those for November and December taken together did indicate improvement from the performance earlier.

Mr. Solomon then presented the following statement:

The Committee already has the surprising news, as reported in the green book,[1/] that the U.S. balance of payments will probably show a surplus on the liquidity basis for the entire year 1968. This came about as a consequence of some massive shifts of funds by corporations and banks in the last week of the year. I shall attempt today to explain this outcome and to place it in perspective.

The Committee will recall that, until the end of the year, we had been looking at a balance of payments for 1968 that was in deficit on the liquidity basis by about $1-1/2 billion and in surplus on the official

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

settlements basis by about $1 billion. The liquidity deficit was held down by a number of special governmental transactions, including purchases of non-liquid Treasury securities by foreign monetary authorities. The official settlements surplus arose from the fact that U.S. banks had borrowed about $4 billion of Euro-dollars from their foreign branches, thereby absorbing dollars that would otherwise have gone into foreign official reserves.

The payments position on both bases had been helped significantly by a substantial inflow of foreign capital into U.S. equities and by a net repayment of loans to U.S. banks and other financial institutions under the voluntary foreign credit restraint program. The Commerce Department program had not, through the third quarter, made its contribution to the balance of payments, in terms of a reduction in net outflows of U.S. funds to finance direct investment abroad. U.S. corporations had borrowed heavily in Europe but had built up very large deposits abroad with the proceeds of these borrowings. Under the Commerce program, they were required to meet their target only on a full-year basis, and could therefore wait until year-end.

That brings us to the last week of 1968. During that week U.S. banks sold some $300 million of assets to their branches abroad. These sales improve the balance of payments on the liquidity basis, since they reduce U.S. liabilities to foreigners--in this case foreign branches of U.S. banks. More important was the repatriation by U.S. corporations of a substantial sum--running into hundreds of millions--to their home offices. This transfer not only fulfilled the obligations of corporations under the Commerce program but probably over-fulfilled it. As corporations shifted deposits they held abroad--perhaps largely in U.S. bank branches--to the United States, U.S. liabilities to banks abroad--including branches--declined correspondingly, and this improved the balance on the liquidity basis. In the last week of the year, liabilities of U.S. banks to their branches fell by more than $900 million. Whereas normally such a drop would be associated with a deficit on the official settlements basis as dollars returned to branches were made available in Europe and seeped into official reserves, this time there was a surplus on the official settlements basis, for the drop in liabilities to branches was the counterpart of net payments of dollars to the United States. To compound the story further, in the latest week--ending January 8--there was a further increase in U.S. head office liabilities to branches of

$1.4 billion, related to outflows from Germany, and another surplus on the official settlements basis.

The question is, what are we to make of all this? Is it all just window dressing and to be ignored or did something significant happen? Although we have only preliminary and scattered facts, I shall go out on a limb and say that I think we should take seriously at least a part of the apparent improvement in the balance on the liquidity basis.

As noted earlier, the corporations under the Commerce program borrowed heavily in the Euro-bond market earlier in the year but kept much of the proceeds on deposit abroad. These borrowings did not show up in the balance on the liquidity basis until brought home at the end of the year. But insofar as these liquid funds were deposited in U.S. bank branches abroad and loaned by them to their head offices earlier in 1968, they contributed to the surplus on the official settlements basis earlier in the year. The end-of-year transactions by which U.S. corporations switched deposits to home offices and thereby switched deposits from banks abroad to banks at home merely permitted the balance on the liquidity basis to catch up, as it were, with the balance on the official settlements basis. Another way to put this point is to say that the official settlements surplus earlier in the year represented not only the absorption by U.S. banks of Euro-dollars stemming from reserve losses by France and the United Kingdom but also dollars from Euro-bond borrowings by U.S. corporations. If the proceeds of these Euro-bond borrowings had been switched to head offices immediately--or had substituted for direct investment outflows immediately--the balance on the liquidity basis would have looked better earlier in the year. As it turned out, this effect was delayed until the last week of the year.

Assuming I haven't lost you, let me now ask whether all these transactions are likely to be reversed early in 1969. Some of them have been. Banks bought back $100 million of the $300 million of the assets they sold to branches in late December. The deficit in the first week of the year was $400 million on the liquidity basis, larger than usual. On the other hand, not all the end-December inflow will be reversed. A good part of it was necessary in order that the corporations might meet their targets under the Commerce program. To the extent that the corporations repatriated more funds than required under the Commerce program, they have the choice of putting the funds abroad immediately or keeping them at home and giving themselves more leeway for direct investment outflows later in 1969. We can't predict what they will do but surely tight money at home will have some influence on their behavior.

From what has been said, I would not expect anything like a complete reversal of the end-of-year inflows.

Now, what can we say more broadly about the status of the U.S. balance of payments? Has equilibrium been established now that we have had a surplus on both bases of calculation in 1968?

There was certainly improvement in 1968 in the over-all position. The Federal Reserve and Commerce programs produced more than their intended results and the inflow of foreign private funds to the U.S. stock market was an unexpected bonus. Investment income and other non-merchandise accounts also showed a gain. These factors add up to something like a $4-1/2 to $5 billion improvement, against which must be set the $3 billion deterioration in the trade surplus.

Another part of the apparent improvement from 1967 to 1968 comes in governmental transactions of various sorts: purchases of long-term deposits and non-liquid Treasury securities by foreign monetary authorities and advance debt repayments. Although some of these transactions may be regarded as window dressing, they can also in part be viewed as the counterpart of political understandings between the United States and other countries--for example, as Germany's quid pro quo for U.S. military expenditures. Insofar as these transactions have such a political basis and can be expected to continue and to be renewed on maturity, it is misleading to label them as pure window dressing and ignore them. On the other hand, some of the special transactions--for example, Canada's investment of her liquid reserves in non-liquid Treasury securities--cannot be repeated.

The improvements in 1968 resulting from the Federal Reserve and Commerce programs are unlikely to be repeated in 1969. Certainly the Commerce program is unlikely to yield another $1 or $1.5 billion. The outcome of the Fed program, under which there is leeway for an outflow, will no doubt depend largely on monetary policy here.

Investment income ought to rise again and hopefully the trade surplus will increase significantly. Hopefully the inflow of foreign equity capital will also continue

> but here we have no bases for prediction. If one puts all this together, there is the possibility that somewhat larger outflows under the Commerce and Fed programs--by more than $1 billion--and smaller special transactions would be offset by larger earnings on trade and invisible account. This might leave a relatively small liquidity deficit and a tolerable balance of payments in 1969--tolerable in the sense that the U.S. balance of payments itself is unlikely to induce unrest in exchange or gold markets or large foreign purchases of gold from the United States. The official settlements basis is likely to stay in surplus as long as tight money continues here and funds are attracted from European reserves to the Euro-dollar market. But a reversion to easy monetary conditions here combined with tight money in Europe could lead to substantial reflows of Euro-dollars from the United States. This analysis does not take account of any possible benefits from a cessation of hostilities in Vietnam.
>
> The tolerable payments position I see for the period ahead thus depends on the capital control programs and on tight monetary conditions in the United States. A more durable position depends on a sizable rebuilding of the U.S. trade surplus.

Mr. Solomon added that the figures for U.S. international payments in the fourth quarter and the full year 1968 were based on preliminary calculations. The official figures would not be released for about a month if the regular publication schedule were followed.

Mr. Daane remarked that he would expect the figures in question to be made public in advance of the regular schedule.

Mr. Brimmer agreed, noting that they might be mentioned by the President in his State of the Union Message this evening. If not, they were likely to be reported shortly in some other connection.

Chairman Martin then called for the go-around of comments and views on economic conditions and monetary policy, beginning with Mr. Treiber, who commented as follows:

Inflationary forces are strong, and most sectors of the economy are vigorous. Wholesale prices have continued their renewed advance. Consumer prices have been rising rapidly at the highest rate in more than a decade and a half. The demand for labor is strong, and unemployment is low. Residential construction and business construction are vigorous. Industrial production continues to advance strongly.

Retail sales have weakened, partly because of the flu epidemic and perhaps also because the income tax surcharge is beginning to have an impact. With retail sales failing to maintain the high upward thrust to which merchants had become accustomed through so much of 1968, trade inventories have risen. Inventories are a sensitive area and will have to be watched carefully.

An unprecedented inflow of capital in the closing days of 1968 created a massive recorded liquidity surplus in our international balance of payments for December, resulting in a surplus of probably several hundred million dollars for the year 1968.

Altogether during December, United States corporations appear to have repatriated as much as $1 billion of balances borrowed during 1968 in foreign bond and loan markets by their U.S.-incorporated investment financing affiliates and their foreign-incorporated operating affiliates. These funds, which presumably were expected to be used in part for direct investment expenditures in 1969, have been used to refinance earlier direct investment outflows and--at least for the time being--to improve the cash position of their large American parent corporations. An incidental effect of the large-scale shift of funds was to escalate rates in the Euro-dollar market which were under pressure from year-end adjustments and the run-off of CD's. The return flow of corporate funds from Europe, together with sales of loans by the head offices of American banks to their foreign branches and sizable special transactions negotiated by our Treasury, helped to produce an estimated recorded liquidity surplus for December of more than $2 billion.

Despite a surplus in the recorded liquidity balance for 1968, and an even greater surplus in the official settlements balance, we continue to have a severe balance of payments problem. The underlying liquidity balance for 1968 was in deficit by more than $2 billion. The merchandise trade balance which deteriorated so greatly in 1968 as imports burgeoned will still remain a problem in the coming year. I hope that the recorded balance of payments surplus in 1968 will not obscure our basic balance of payments problem and create a euphoria which can only worsen the long-run adjustment problem.

Analysis of the domestic financial data is unusually difficult because of the turbulence in the markets resulting from the recent tightening of monetary policy and year-end adjustments. Bank credit and deposit growth apparently remained substantial in December, but a marked slowdown now seems to be in progress. There was a big run-off of large certificates of deposit in December, particularly at the New York City banks, and there is widespread apprehension that large-scale attrition will continue. Conceivably a further large and rapid reduction in CD's could cause the banks to panic, and to bid even more aggressively for Euro-dollars, to dump municipal securities on the market, and to cut loans sharply. But to date there is no evidence of such a frantic search for liquidity. The limited information available with respect to thrift institutions indicates a somewhat weaker deposit experience in December. A continued and sustained rise in market rates could make their position increasingly difficult. Capital market demands remain quite heavy despite the very high level of interest rates. The Treasury is offering today $1-3/4 billion of June tax-anticipation bills to raise needed cash, and will be announcing a major refunding at the end of this month.

With two increases in the prime rate since the mid-December rise in the discount rate, some increases in personal loan rates, and rapid increases in market rates, there has been a great change in market psychology. The markets have generally interpreted our actions as a determined effort to break the back of inflationary expectations. This is all to the good. More time will be needed for markets to stabilize and to permit a better assessment of the impact of the sharp change in financial conditions on business sentiment and bank lending.

It seems to me that, broadly speaking, credit policy should continue its recent stance. With no change in policy one might expect to see (a) Federal funds rates generally in a 6-1/4 to 6-1/2 per cent range, probably more frequently in the higher part of the range or even exceeding the range; (b) member bank borrowings generally in a $550 to $800 million range; and (c) net borrowed reserves generally in a $250 to $600 million range.

Fortunately, the current credit proxy projections for January show a lower rate of credit growth. Under such circumstances, the two-way proviso in the directive suggested by the staff appears appropriate, with the expectation that an upward deviation should be resisted sooner and more vigorously than a downward deviation. The reference to the Treasury refunding also is appropriate. Because of sensitive market conditions it would also seem desirable to keep open market operations flexible, particularly if abnormal liquidity pressures develop. I would accept the suggested directive.

It seems to me that a further increase in the discount rate would not be desirable at this time in the light of the present sensitive market atmosphere and the reduced credit availability that has developed in recent weeks. Nor does it seem appropriate in these circumstances to give an overt signal of further tightness in the form of an increase in reserve requirements. On the other hand, we should be careful not to let a seasonal decline in market pressures, if it should develop, lead the market to the conclusion that we are backtracking from a policy of restraint. We have gotten a good reaction so far to our policy moves, but there is still a long way to go before we can be sure that inflation is under control.

It is clear that the maximum rate permitted under Regulation Q for large certificates of deposit is creating heavy market pressures. There have been large run-offs of CD's and heavy pressure on the Euro-dollar market. Continuation of the existing ceilings will restrict overall deposit and credit growth in the coming months. Since this goal is desirable, I would not recommend any change in Regulation Q ceilings at this time. Of course, if extreme liquidity pressures should develop, or if it became clear that use of the Euro-dollar route by the banks to offset these pressures were placing a severe strain on foreign currencies, an increase in the ceilings might be needed promptly. It would be preferable, however, to make flexible use of open market operations to avoid the need to raise Regulation Q ceilings, provided it could be done without misleading the market.

Mr. Morris said that the blue book projections had given him cause for concern, since they suggested that the monetary policy now in force would be substantially more restrictive in January and February than the policy he thought he was voting for at the last meeting of the Committee. The monetary policy he favored was one that would cut roughly in half the 13 per cent annual rate of growth of bank credit recorded in the last half of 1968. Given the fiscal restraint at work in the economy, an annual rate of growth of 5 to 7 per cent in bank credit would seem to be an appropriate guideline for the first half of 1969.

However, Mr. Morris continued, according to the blue book projections current policy would be much more restrictive than that. A growth rate of 0 to 3 per cent in the proxy was forcast for January and, although no specific forecast was presented for February, the text suggested that growth in that month was likely to be zero to negative. That would constitute a severe swing from the 13 per cent rate of growth of the proxy in the past six months--in his judgment, an excessive swing. The state of the economy called for a substantially less expansionary policy than was followed from July through December but it did not, in his opinion, warrant the sort of policy described in the blue book. The Committee should give recognition to the fact that it was dealing with a decelerating economy, even though the pace of deceleration had been rather disappointing during the past 6 months.

Mr. Morris remarked that the response of the market to the change in monetary policy had been constructive thus far. The System had put a dent in inflationary expectations without, as yet, generating any widespread fear that policy would be unduly restrictive.

There was concern in the financial community but no sense of panic. The major Boston banks with large CD positions were well aware of the adjustment problem which they faced in the months ahead and were in the process of tightening their lending and investment policies.

The cutting edge of the new policy, Mr. Morris said, was formed by the Regulation Q ceilings, and that was a very blunt and unwieldy policy instrument. It was a difficult instrument not only for the Manager to deal with in fine-tuning the market, but also for the Board's staff to deal with in forecasting monetary aggregates. In wielding that blunt instrument, there was a clear risk of producing an excessively restrictive policy, unless the Committee made it clear to the Manager that it was seeking a slower rate of growth of bank credit, not a leveling off or a contraction. If that was, in fact, the intention of the Committee, he thought it would be desirable to change the language of the directive. Specifically, he would suggest replacing the proviso clause shown in the staff's draft with the following language: "provided, however, that operations shall be modified to the extent necessary to assure a modest rate of growth in bank credit."

Mr. Morris added that he was concerned with the suggestion in Mr. Keir's statement that under current policy there was a fairly good chance of a credit crunch in January. It was clear that the state of the economy did not call for a drastic monetary remedy of a kind that was likely to lead to disorganized markets such as had developed in 1966. Moreover, if there was a credit crunch the System might have to take measures to deal with it that would produce excessive rates of growth in bank credit. Accordingly, he would much prefer a more moderate degree of restraint at this juncture than that indicated by the blue book figures.

Mr. Coldwell reported that the Eleventh District economy was at a very high level. There had been some industrial production declines, with strikes and reduced oil output largely responsible. However, employment, construction, and retail sales had reached new record levels. Agricultural conditions reflected seasonal slackness and a period of reappraisal of last year's efforts. Cotton continued to be held off the market in hopes of a better price.

District financial conditions reflected seasonal factors and a continued strong loan demand, Mr. Coldwell said. Loans, investments, and demand and time deposits all advanced through the close of 1968. CD runoffs had been largely those scheduled and in total were relatively minor.

Bankers reported a continued availability of lendable funds and a strong demand, Mr. Coldwell continued. Customers had not yet reduced their demands for credit and seemed unconvinced that the inflation would be slowed markedly. The banks were not under any real pressure for funds and, in fact, with a seasonal slack in agricultural demands, the small country banks were looking for participations. Failing to find such correspondent accommodation, the small banks were enlarging their sales in the Federal funds market. There were now about 240 District banks in the Federal funds market--more than one-third of all member banks in the District.

Mr. Coldwell remarked that a review of the national economy indicated to him that the forward momentum had not as yet been materially checked by fiscal or monetary restraint. In the financial area, there had been a sharp run-up in yields and interest rates with some pressure beginning to develop at large money-market banks. However, the reduction in credit availability came primarily from the run-off of large-denomination CD's which had been concentrated at the large banks. Even at those banks, though, pressures had been moderated by access to the Euro-dollar market, and the restraint had not yet been sufficient to force major changes in lending practices nor to force major borrowers to reach down to interior banks.

Mr. Coldwell thought one had to admit that the higher rate levels had not caused a significant reduction in credit demands. Apparently, the inflation psychology was still strong. Borrowers were willing to pay the higher rates because they expected prices and costs to increase. There had been only a short time to measure the impact of higher rates, especially as they might impinge upon borrowers' demands or cause CD run-offs. Nevertheless, whatever pressures on reserves had developed at the large banks had not yet filtered down to the interior banks.

As to policy, Mr. Coldwell said, despite the apparently slow impact of the fiscal and monetary restraints, he believed the Committee could wait for a further period to see if the desired results were forthcoming. The problems of visibility in the present period of seasonal change and the adjustments under way in the economic and financial sectors argued for a policy of steadiness, holding the degree of restraint at present levels. He could not counsel too strongly that the Committee hold to the present course of policy until it could see that significant improvement had been achieved in the fight to break the inflation psychology and reduce credit demands to sustainable levels. As he had indicated, he was not convinced that that had been accomplished, and he thought that further tightening measures might well prove necessary.

Mr. Swan reported that the Twelfth District economy also had continued strong. In California, the unemployment rate had declined from 4.4 per cent in November to 4.2 per cent in December. There had been a slight reduction in the labor force; employment had remained essentially unchanged. In November seasonally adjusted housing starts in the West were at their highest level in four years. Although the rise in the West was smaller than in the rest of the country in November, it was substantially greater for the first eleven months as a whole; through November, Western housing starts were up about 34 per cent from the comparable 1967 period, compared with an increase of some 14 per cent in other areas.

Mr. Swan noted that in December business loans had expanded considerably at District weekly reporting banks and there had been a run-off of large-denomination CD's. However, the CD run-off was not as substantial as at weekly reporting banks elsewhere and it was smaller than that experienced by District banks in the corresponding period of 1967. Similarly, expansion in total time and savings deposits--including interest credited--was larger in December than a year earlier. Nevertheless, major banks in the District expected deposit losses, including further CD run-offs, in January and February, and they thought their reserve positions would be under some pressure. As a consequence, there had been a substantial increase in advertising of a wider variety of forms of "consumer" CD's, which the banks described as a "defensive" measure.

The situation at District savings and loan associations was not clear, Mr. Swan said. While the green book reported the rather unsatisfactory experience in the last few days of 1968, the San Francisco Reserve Bank's limited sample of five large associations indicated that there had been a small net inflow in the first ten days of January. The inflow was of about the same magnitude as in the corresponding period a year ago, and the institutions had been rather pleased by it. The sample was, of course, very small and any conclusions drawn from it were highly tentative.

In addition to the prime rate increase, Mr. Swan continued, there had been increases in interest rates on mortgage loans at some of the larger District banks and there was talk about increases in rates on consumer loans. Those banks were now less interested in acquisition loans and in business loan participations except for their regular customers, but it appeared that they had taken few if any steps to restrict loans to their customary business borrowers.

During the first week of the year, Mr. Swan observed, there had been a considerable easing in the reserve positions of the major District banks, and in the current week--at least as of last Thursday--they expected to be net sellers of Federal funds. Apparently, a substantial volume of money was available to the banks through corporate repurchase agreements, perhaps involving funds repatriated from Europe or raised in the commercial paper market and not immediately used. Whatever the source of such funds, their availability might well be temporary.

Turning to policy, Mr. Swan said that in his judgment the firmer money market conditions recently attained were desirable and should be maintained for the time being. He saw no reason for a change in policy at this point even apart from the forthcoming Treasury refunding. The slackening in retail sales in December, the recent rapid growth in inventories, seasonal factors, and the expected continuing run-off of CD's all suggested some further significant moderation in the rate of economic expansion. However, he would be willing to maintain the present posture of policy even though a low rate of bank credit growth was projected for January. If one considered December and January together, the current rate of bank credit growth did not appear unduly low. The Regulation Q ceilings had a good deal of significance in terms of the market's evaluation of the System's policy intentions, and he hoped they would be maintained at their present levels if at all possible, even if liquidity pressures proved to be somewhat greater than now expected. If it was necessary to relieve such pressures, he would prefer to see additional reserves provided through the discount window or by open market operations under the proviso clause, rather than to have the Q ceilings raised.

On that basis, Mr. Swan concluded, he could accept the second paragraph of the staff's draft directive as written. With respect to the first paragraph, he questioned one clause in the final sentence containing the description of the Committee's general policy stance--the clause which described one of the Committee's objectives as that of "attaining a reasonable equilibrium in the country's balance of payments." He did not want to exaggerate the importance of the surplus that had been recorded for the year 1968; from a longer-run viewpoint, the payments balance was likely to continue to be a serious problem. But since there had, in fact, been a surplus last year the language in question struck him as inappropriate. Perhaps it would be desirable at this point to replace it with a statement of objectives in terms of the trade balance, such as, "enlarging the favorable balance in the country's merchandise trade accounts."

Mr. Galusha remarked that the pace of economic advance in the Ninth District might well be slowing. There had been a 25 per cent decrease in prime defense contract awards in the third quarter of last year. That sharp decrease might explain the recent relatively modest increases in District manufacturing employment. Government employment had also been increasing relatively modestly of late.

Mr. Galusha said that the Minneapolis Reserve Bank's most recent survey of country banks, completed only a week or so ago, indicated that farm incomes had been increasing, but that there had been no increase in the willingness of farmers to spend--whether for consumer durable goods or for farm equipment. The survey also indicated that, as a group, country bankers were expecting no trouble in meeting what might be an unusually large early-spring loan demand. Apparently, the weather was so bad last fall that farmers could not prepare their fields, and so put off borrowing until spring. Obviously, there could be trouble if the inflow of time and savings deposits to the country banks decreased appreciably; but so far there had been no hint of such a decrease. In fact, their condition generally paralleled that reported by Mr. Coldwell for the Eleventh District.

Turning to Committee policy, Mr. Galusha commented that with the bits of information which had come in recently, it was easy to accept the Board staff's projection of some slowing in the national economy's pace of advance. Quarterly increases in current-dollar GNP averaging $12 to $13 billion appeared quite reasonable for the first half of 1969. He would not rule out smaller average increases. He had only his intuition to go on, but consumers might well do even less buying--particularly in the first quarter of the year--than Mr. Brill and his colleagues expected; and he (Mr. Galusha) had not been persuaded by the latest OBE-SEC survey, even before talk of another credit crunch had become widespread.

Accordingly, Mr. Galusha observed, things were looking up. Of course, insofar as the Committee was concerned, the first half of 1969 belonged more to the past than to the future. The Committee should be thinking about the second half of the year, and more particularly about whether, with no further changes in monetary policy, the pace of economic advance was going to increase again. He had seen forecasts--authored, he should add, by respected forecasters--of quarterly increases in current-dollar GNP of not $12 to $13 billion but rather of $17 billion or so. And those forecasts were based on the assumption of a continuing 10 per cent tax surcharge. He believed they were too bullish, but perhaps by only a shade. Anyway, it was clear that the issue of the surcharge had returned to plague the Committee.

In the fond hope that the issue would soon be resolved one way or the other by the new Administration, Mr. Galusha remarked, he would suggest that the Committee keep policy unchanged, and that the Manager be directed to maintain the three-month bill rate within a narrow range--from 6.00 to, say, 6.20 per cent--until the next meeting.

If a real scarcity of three-month bills were to develop the rate might be permitted to drop below 6.00 per cent, but not much below.

Mr. Galusha said he thought the Committee should recognize that it was presently playing a dangerous game. Squeezing the money market banks--and, to a lesser extent, the other banks and nonbank thrift institutions as well--against unchanged Regulation Q ceilings might be an effective way of curbing the growth of bank credit, at least in the short-run; but depending on what money market rates averaged over coming weeks, disintermediation would be slight or considerable. And, as he was sure everyone would agree, how much disintermediation there was made a difference.

To Mr. Galusha's mind, the implication was that the Committee should take the three-month bill rate as its operating target. Certainly now was not the time for turning to bank reserves or some other quantity target. He would remind the Committee that Professor Milton Friedman had on occasion--not always, but on occasion--acknowledged the impracticability of following a bank reserves or money supply rule so long as Regulation Q ceilings were, as at present, effective. And in the short run it was no answer to say "get rid of Regulation Q."

Mr. Galusha commented that over coming weeks expectations could be quite volatile. With the present Regulation Q ceilings, the Committee could not really afford to let a change in expectations carry the three-month bill rate above 6.20 or 6.25 per cent, even for several days running. Nor could it afford to let an opposite change carry that rate below 6 per cent or thereabouts unless, of course, a severe scarcity of three-month bills developed.

In concluding, Mr. Galusha said he favored the draft directive submitted by the Board's staff, and he would urge that the two-way proviso clause shown in the draft be included. In the present circumstances, such a clause was essential; and it was essential that the Manager respond promptly, particularly to signs that bank credit was going to increase less than expected. If the feel of crisis developed, the Federal Reserve could be forced to come to the rescue of markets; and in that event it would have lost a great deal in its struggle to change inflationary expectations--no one would believe in monetary restraint.

Mr. Scanlon reported that the economic picture in the Seventh District continued to be characterized by low unemployment, widespread price increases, better than expected orders for various manufactured goods, and heavy demands for credit. That view of the economy appeared to be somewhat different from the description of the outlook given in the first few pages of the green book. The language used in the front of the green book seemed to go further in suggesting the development of restraint than did either the green book figures on recent and projected GNP or the evidence available to date on Seventh District developments.

There was some concern in the District that monetary policy would swing too vigorously toward restraint, Mr. Scanlon observed.

However, the predominant view of economists in the area appeared to be that the stringencies associated with the 1966 experience would not be repeated. Although quarterly projections of total spending through 1969 showed diverse patterns, the consensus looked to another year of inflation with continued pressures on labor resources.

Mr. Scanlon said that increases in prices in recent weeks had been more numerous than that at any turn-of-the-year period in the 1960's, and had affected a wide variety of materials and finished goods. District companies expected to pay higher prices, and to charge higher prices, in the months ahead.

The green book suggested that business capital expenditures were likely to be reduced from planned levels, Mr. Scanlon observed. That would be a desirable development and he hoped it occurred. However, there was no evidence of it as yet in his District.

Mr. Scanlon remarked that farm machinery output, the weakest of the major District industries, was not expected to improve in 1969 and, according to one producer, it might decline further on a year-to-year basis. On the other hand, prospects for construction machinery sales appeared excellent. Demand for heavy trucks continued strong. Orders had increased recently for railroad equipment, nuclear power apparatus, air conditioning equipment, machine tools, and components for capital goods.

The dollar volume of construction contracts had been large and a substantial amount of new work was in the planning stages, Mr. Scanlon said. Increasingly, reports were heard of limited availability of construction materials and components in addition to labor shortages. Rents for both dwellings and office space were rising sharply. Multi-family units had accounted for most of the increase in housing permits in the District in 1968, and the increase in starts projected for 1969 also was expected to occur in the multi-family sector. Insurance companies were pushing a variety of plans for financing residential construction, mainly multi-family projects, that included some kind of equity interest.

Mr. Scanlon noted that steel orders--looked upon as a trouble area--had increased each month, and by more than expected, since the late summer low. That trend appeared to have continued into January. Steel consumption was expected to be slightly higher in 1969 than in 1968 despite an anticipated decline in steel used in autos and pipelines. Although steel companies apparently had underestimated consumption and overestimated customer inventories in recent months, excess steel inventories were still being liquidated. As a result, according to the Reserve Bank's contacts, shipments and output of steel were expected to be about 4 per cent less in 1969 than in 1968. Steel prices appeared to be stabilizing--and firming--after the most chaotic period since the 1930's.

Reports to the Reserve Bank from Detroit indicated that auto assemblies would be at 806,000 in January, about the same as the year-earlier level of 808,000, Mr. Scanlon said. First-quarter auto sales were forecast at two million units, about the same as in the first quarter of 1968.

In the financial area, Mr. Scanlon continued, it was difficult to sort out the effects of year-end pressures and reactions to the discount and prime rate changes from more basic trends. Bank loan figures continued to reflect strong credit demand and loan officers did not appear to expect demand to abate in the near future. On the other hand, their reluctance to acquire funds at today's costs for a period of more than two or three months ahead suggested they did expect some weakening in the second quarter. The same could have been said, of course, during most of the second half of last year. Business loans had risen very fast at the large District banks in the past two months. Much of the increase had gone to public utilities and, to some extent, might reflect postponement of capital market financing. But loans to other business borrowers looked quite strong also.

At current market interest rates, Mr. Scanlon remarked, rapid attrition of CD funds was taking place and was beginning to produce fairly strong offsetting action by the banks. There was considerable evidence that some large banks were becoming more restrictive in their lending policies. They were already liquidating investments and reactivating committees of senior officers to review applications for credit. District banks showed a decline in Euro-dollar borrowings and were reluctant to bid for them at current rates. It did not appear that the Euro-dollar market had much potential as an offset. Borrowing at the discount window had been intermittent so far but was likely to increase, as it had in 1966, if the squeeze intensfied.

Assuming that credit demands would not decline abruptly in the next few months, Mr. Scanlon continued, it seemed to him that bank credit could be adversely affected considerably more than in 1966 and with even greater psychological ramifications. In contrast to 1966, all market rates were above CD ceilings on like maturities, with the widest spreads existing at the shorter maturities. Since early December CD's at weekly reporting banks had declined by almost $2 billion, or by two-thirds of the amount of the 1966 decline, although from a level one-third greater. The Euro-dollar market today appeared tighter and probably less readily accessible than in 1966 as a source of funds to offset the decline in CD's.

Mr. Scanlon said he favored continuing a substantially restrictive policy. He recognized, however, that the Committee also had to guard against large, abrupt, or long-continued credit contractions. In the absence of an increase in the Regulation Q ceilings, a slow growth of bank credit could be achieved only through a relatively rapid growth in total reserves and demand deposits. While that might be an acceptable development for a few weeks, it was not a happy prospect if it were to continue for several months, since it would tend to cause an inefficient allocation of credit and would further confuse the interpretation of policy indicators.

The staff's draft directive was acceptable, Mr. Scanlon said, except that he would favor deleting the word "real" from the statement in the first sentence that ". . .expansion in real economic activity has been moderating. . . ." The introduction of "real" at the point where the term "over-all" had previously been used suggested that the Committee was now giving real GNP a priority in its thinking that it had not given it in the past. That was the kind of change he would like to avoid when the Committee was not changing policy.

Mr. Clay remarked that adoption of a monetary policy of restraint at the last Committee meeting had been a good beginning in the effort to fight price inflation and to produce a more sustainable pace of economic growth. That policy would have to be maintained if the System's efforts were to be successful.

Price inflation continued to be very strong and the intense inflationary expectations of recent months showed no signs of abatement, Mr. Clay continued. Considerable time and effort, buttressed by evidence of persistence and positive results, would be required to restore relative price stability and to dispel price inflation expectations. A slower pace of economic expansion had to be part of the process by which the necessary results were attained.

It did not seem necessary to Mr. Clay to move beyond the current degree of monetary restraint at present, but it also was very important that monetary policy not be relaxed. The money market conditions specified in the blue book as likely to be associated with an unchanged policy in open market operations appeared to be reasonable. Those conditions included a Federal funds rate frequently around 6-3/8 to 6-1/2 per cent, member bank borrowings in a range of $550 to $800 million, and net borrowed reserves of $250 to $600 million.

Mr. Clay thought that more importance should be attached to preventing undue expansion of member bank reserves and bank credit. The suggested range of 0 to 3 per cent for the annual rate of growth in the bank credit proxy, apart from some added allowance for Euro-dollar borrowings, appeared to be in order for January. The System should stand ready to accept substantial attrition of CD's.

The Federal Reserve discount rate should be left unchanged, Mr. Clay said. Admittedly, it was out of line with money market rates, and thus it was not entirely appropriate for discount window administration. On the other hand, the announcement effect of such Federal Reserve action did not seem to be necessary, and the interest rate repercussions of the announcement probably would be more detrimental than helpful. The principal need was to limit the amount of credit availability.

The staff's draft of the directive appeared to Mr. Clay to be satisfactory.

Mr. Heflin reported that the latest information on the Fifth District showed some signs of a slackening in the pace of expansion in recent weeks, although the evidence was far from conclusive. The Richmond Reserve Bank's early-January survey indicated some disappointment with Christmas retail sales and a dimmer outlook in residential construction. Manufacturers covered in the survey also reported a tapering off in both new orders and backlogs. On the other hand, most of the Reserve Bank's area contacts reported a continuing boom in business expenditures for new and expanded plant capacity. Banks in the District apparently had not yet begun to feel any tight money squeeze and while most had followed the latest prime rate hike, some did so reluctantly.

At the national level, Mr. Heflin continued, upward price pressures persisted but excess demand in the economy seemed to be associated mainly with expenditures in the business sector. Consumer outlays appeared to have moderated and prospects were that they would continue to do so. Under the circumstances the recent spurt in inventory spending was likely to be transitory and there was at least a possibility of some scaling down of business capital investment plans. Considering the budgetary changes now in process, and the System's recent tightening moves, it seemed to him that there almost certainly would be a significant moderation in the business expansion in the months ahead. It might be that there would be more moderation than bargained for, but he believed that that was a risk that had to be taken if the inflationary climate was to be dissipated.

Mr. Heflin noted that there seemed to be some doubt that the System's latest moves had convinced the market of its determination to contain inflation. Nonetheless, rate increases since the Committee's last meeting, and especially the two rapid-fire prime rate hikes, had rather clearly produced an impact on market expectations patterns. Recent movements of bond and stock prices suggested growing doubts about the continued buoyancy of the business advance. Such expectations should, of course, strengthen the tone of credit markets generally. Yet it seemed to him that at the moment markets were still in a nervous and uncertain state. In the light of the likely CD situation over the next two weeks, he thought the System would still have to face up to the possibility of a credit crunch that might make it difficult for borrowers to raise funds even at high rates.

As for current policy, Mr. Heflin felt that there was no room for further tightening at this time. Accordingly, he favored the draft directive submitted by the staff. But he wanted to say that it would be a mistake, in his judgment, to back away from the current posture of policy at the first sign of a break in the boom. Even in the face of a crunch created by large CD run-offs, he believed he would be inclined to move with caution and to avoid any major effort to compensate reserve losses through large open market purchases. It might be better to encourage banks to use the discount window to make up any losses that might occur, even if that might involve a large increase in borrowings.

Mr. Mitchell said he agreed with the views expressed today by the staff and by Mr. Treiber. Unlike Mr. Morris, he would not be concerned if the bank credit proxy increased only slightly or not at all for a month or two, following the 13 per cent annual rate of growth experienced over the second half of 1968. He would not want to see bank credit growth sharply curtailed for an extended time, but under current circumstances he would be inclined to assess its performance in terms of the average rate of growth over a period such as the four months from November through February. If the 11-1/2 per cent growth rate of November and December--allowing for Euro-dollars--were averaged with projections for January and February, the average rate of expansion would be found to be about 6 or 7 per cent, and that seemed appropriate in the present environment.

Mr. Mitchell noted that the liquidity positions of various sectors of the economy--including banks, corporations, and consumers--were very good at present, and far better than they had been in 1966. It seemed, therefore, that the System would have to maintain a policy of substantial restraint for some period of time if it were going to accomplish its objectives. He wanted to avoid a credit crunch, and although he did not think the current degree of restraint would produce one, he would urge the Manager to watch developments carefully. At the same time, he would emphasize the need to guard against an undue increase in the bank credit proxy.

Mr. Mitchell added that he was somewhat disturbed by the recent movements in the money supply. The reasons for the sharp increase around the turn of the year were not wholly clear, but he was satisfied that the staff's explanations were the best that could be made. In any case, he would focus on bank credit rather than on the money supply. With respect to the policy statement about the balance of payments in the first paragraph of the directive, he agreed with Mr. Swan that recent developments made the present language obsolete, but was not sure what alternative language would be desirable.

Mr. Daane remarked that Mr. Solomon's statement on the balance of payments had been thoughtful and lucid, and offered a realistic appraisal of the outlook for 1969. He accepted Mr. Solomon's conclusion that there had been a significant improvement in the balance, and that not all of the massive inflow before the end of the year would be quickly reversed. But he also shared the view--which Mr. Treiber and others had underscored--that a serious payments problem remained. The fact that there had been large inflows of funds just before the year-end did not justify the conclusion that the objective of a sustainable equilibrium in the payments balance had been achieved. Accordingly, he would not favor changing the policy statement on the balance of payments in the directive.

Mr. Daane said he thought the comments by Mr. Morris concerning prospective bank credit developments had been helpful in sharpening the issue. However, he (Mr. Daane) had come to an opposite conclusion. In Mr. Morris' judgment there was nothing in the economic outlook that justified risking a credit crunch or that warranted accepting bank credit behavior in January and February of the kind projected in the blue book. He (Mr. Daane) thought the risks with which Mr. Morris was concerned were far less important than the opposing risk that the Committee might contribute further to the inflationary expectations that were currently prevailing. He was concerned by the Manager's suggestion that there was still a good deal of skepticism in financial markets regarding the System's determination to hold to its present policy course as long as necessary. He joined those who hoped that the System would continue to indicate by its actions that it had the courage to stand fast. While he decried the clumsiness of Regulation Q ceilings as a policy device and had no desire to produce a credit crunch, he thought the Committee presently was on the right course in its efforts to dampen inflationary expectations, and he would not want to see it deviate from that course. He favored adopting the directive as drafted by the staff.

Mr. Maisel said he would make only two brief observations. First, he thought the Manager should be prepared to react rapidly if bank credit developments called for implementation of the proviso clause. Secondly, be believed the second paragraph of the draft directive gave undue prominence to the Treasury's February refunding, since operations in a large part of the forthcoming policy period would not be subject to even keel constraints. To avoid confusing the historical record, he would prefer to excise the two references to the refunding from the draft, and add a statement at the end of the paragraph to the effect that the refunding should be taken into account when it became imminent.

Mr. Brimmer said he wanted to join in complimenting Mr. Solomon for an effective job of unraveling the complex balance of payments figures. He (Mr. Brimmer) would add that apart from uncertainties with respect to the basic economic developments that would affect the payments balance in 1969, there was also considerable uncertainty regarding the life expectancy of the Government's balance of payments programs. At this stage no one could say with confidence whether, or in what form, the Commerce program--which had made the main contribution to the improvement in 1968--would be continued. There was also some uncertainty about the views of the new Administration concerning the voluntary foreign credit restraint program administered by the Federal Reserve. In connection with that program, as the members knew he had sent out letters to all the Reserve Bank Presidents announcing a series of meetings with Federal Reserve Bank officers and with representatives of the banks and of other institutions participating in the program. The information gathered at those meetings would help the Board in carrying out an evaluation of its guidelines and would provide the Administration with an essential basis for its basic policy decisions. He would represent the Board tomorrow (January 15) in hearings on the voluntary foreign credit restraint program before the Subcommittee on International Exchange and Payments of the Joint Economic Committee.

Turning to the directive, Mr. Brimmer indicated that he did not agree with the language change proposed by Mr. Swan in the policy statement about the balance of payments. There was no assurance that equilibrium had been achieved in the country's external accounts. Even apart from doubts about the duration of the surplus, he saw no reason to change the statement since reasonable equilibrium in the balance of payments remained the Committee's objective.

Mr. Brimmer said the directive as drafted by the staff was acceptable to him. Unlike Mr. Morris, he would not be particularly disturbed if the rate of growth in bank credit over the near term were to drop substantially below the average rate of the fourth quarter. He was prepared to see the money market banks lose a substantial portion of their CD's. He hoped that such losses would lead banks to curtail loans to business customers, since the investment outlays currently planned by businessmen were too large, and that the rate of growth in the monetary aggregates would slow. In short, he would favor a determined policy of credit restraint. Such a course seemed particularly necessary to him in light of the doubts reported this morning concerning the System's determination.

Mr. Sherrill said that he too wanted to commend Mr. Solomon on his presentation. It was one of the few appraisals of the balance of payments he had heard recently in which positive accomplishments were not described as unreal and negative developments as the tip of an iceberg. However, nothing in Mr. Solomon's analysis offered grounds for great optimism or suggested the need to change the policy statement on the payments balance in the directive.

In the domestic area, Mr. Sherrill continued, the key economic problem was that of dealing with bullish business expectations. Such expectations might well lead to an undue expansion in capital outlays and inventories, and to subsequent problems associated with the unwinding of such investments. Recent developments provided strong evidence that high interest rates alone were not the solution to the problem. Businessmen were so optimistic about economic prospects that they were willing to borrow at very high interest rates. Tight control over the availability of credit was likely to be the most effective approach; growth in bank credit had to be curbed.

Accordingly, Mr. Sherrill observed, he favored maintaining the current policy of restraint. He recognized that there were risks in such a course and that the present degree of restraint was essentially a policy for the short run. He would want to be alert to any tendencies toward changing expectations in order to prevent an over-reaction. For the present, however, he would have the Manager watch developments carefully and avoid signaling easing of any kind through his operations. He would accept the directive as drafted by the staff.

Mr. Hickman commented that although economic activity continued to expand rapidly, there were scattered indications of easing, especially in the consumer sector. Retail sales had rebounded in November but had failed to return to the August high, and then had dipped significantly in December. The extent to which that dip was related to the Hong Kong flu was debatable. Sales of new domestic cars in November and December were considerably less than the 9 million annual rate that had been a floor since last spring, and January sales would probably hold at the reduced level. Latest surveys of consumer sentiment and buying plans also appeared to rule out renewed vigor in that sector. If consumers behaved as now seemed likely, the growth of GNP this quarter, and perhaps next quarter, would depend largely upon inventory investment. Nevertheless, the recent acceleration of wholesale prices for industrial commodities and the continued sharp advance in consumer prices were likely further to fan inflationary psychology.

In that environment, the current objective of monetary policy appeared to Mr. Hickman to be about right, providing the Desk held to a fairly firm and narrow course without major deviations in either direction. As he had stated at the last meeting, the appropriate policy in the present situation seemed to him to be "credit restraint, not a crunch." In that regard, he had to admit to a few moments of doubt since the last meeting, when intermittent run-ups in bill rates appeared to be leading to excessively large run-offs of CD's.

It seemed to him, Mr. Hickman continued, that in the period immediately ahead the System should strive for a rate of bank credit growth just a shade less restrictive than that outlined in the blue book. The blue book projected a rate of credit growth in January, excluding Euro-dollars, of zero to 3 per cent, augmented to 2 to 5 per cent when Euro-dollars were included, and a 91-day bill rate in a range of 6 to 6-1/4 per cent. In his opinion, it would be slightly more desirable to keep the bill rate in a 5.90 to 6.15 per cent range, which would perhaps permit bank credit growth in a range of 4 to 6 per cent. That policy would lessen the likelihood of a sharp CD run-off and would reduce dependence on Euro-dollars.

In any event, Mr. Hickman said, the difference between his prescription and the staff's was not large and he was prepared to vote for the staff's draft directive. He would prefer, however, either to delete the references to the Treasury refunding or to make a modified reference along the lines of that suggested by Mr. Maisel, since the terms of the refunding would not be announced until shortly before the Committee's next meeting. Since the present was a period in which minor differences in market conditions could have major effects on market expectations and the flow of funds, the Manager should be given more than usual latitude to achieve the Committee's objectives.

Mr. Bopp observed that, as usual, the choice today involved a comparison of the costs and benefits attached to the various policy alternatives. But the choice was unusually difficult because the alternatives had potentially heavy and immediate costs attached to them against which uncertain benefits had to be weighed.

Arguing for further restraint, Mr. Bopp said, was the dearth of signs that excessive growth in the economy had yet been brought under control. Locally, the Philadelphia Bank's December business outlook survey showed that two-thirds of the executives polled expected a more buoyant economy by mid-1969. That confidence indicator had been rising since last September. In addition, inflationary sentiments had increased.

As for the national economy, Mr. Bopp continued, in spite of the December decline in retail sales, it was still far from certain that the pressures from excessive growth were subsiding. Moreover, policy decision made now would have much of their impact in the second half of the year when some of the restraining influences on consumers would be appreciably less. Growth in the credit proxy during December had again been large. Although a slowdown was forecast for January, that forecast had to be interpreted in the light of excessive growth of bank credit since midyear and its persistent tendency to grow faster than expected.

All of those facts pointed to the need for some further restraint, Mr. Bopp said. On the other hand, a strong case could be made for not rocking the boat. Banks were tightening lending policies as their supply of CD money had become uncertain. Money markets had tightened since the increase in discount rates. Further restraint would make an already nervous money market still tighter. Orderly disintermediation could turn into a rout. Nevertheless, in his judgment the potential costs of inaction were so great that the risks attached to a policy of more restraint had to be taken. He was all the more persuaded of that in view of the approaching period of even keel in February which would probably preclude any policy move until some time in March.

However, in view of the risks attached to further restraint, Mr. Bopp thought the choice of policy tools was particularly important. Any overt change in policy was inappropriate now. Expectations were currently of critical importance to short-term stability in the money markets. They were likely to continue to be so. Because of the difficulty of judging the impacts of policy changes on those expectations, the System had to test and probe their impacts. The flexibility and reversibility of open market operations made them the ideal tool for that approach.

Mr. Bopp's recommendation was for some additional restraint, with bill rates and Federal funds rates at the upper end of the ranges projected in the blue book. He would, however, give the Desk discretion to use the tactics it thought appropriate in achieving that restraint, including freedom to offset any overreaction of money market rates. With that qualification, he could accept the directive proposed by the staff.

Mr. Kimbrel observed that a review of the latest economic and financial data strongly suggested to him that the somewhat firmer policy adopted by the Committee at its last meeting had not yet achieved the desired slowing in the growth of bank credit and in the economic expansion. One could hardly expect that in so short a time.

The original green book estimates of commercial bank loan and investment growth at a seasonally adjusted annual rate of around 6 per cent in November and December had given him some comfort, Mr. Kimbrel said, by suggesting that the Committee might be approaching its goal. However, the later revised estimate of a 10.1 per cent growth rate for December had had the opposite effect. The revised December estimate for the nation, incidentally, more nearly conformed to the Atlanta Bank's estimates of a continued strong growth in loans and investments at Sixth District banks. Preliminary estimates showed a seasonally adjusted annual rate of growth of over 20 per cent at the large banks in December. That rise was not explained by security loans and loans to non-bank financial institutions. Consumer and real estate lending was strong despite a slowdown in business lending. The banks also added to their Government security holdings, especially Treasury bills. Losses of large-denomination CD's were relatively small.

One could not be very certain, Mr. Kimbrel remarked, that the sharp rise in money market rates could be attributed primarily to the change in monetary policy rather than to expectational factors and technical forces. There were some grounds, of course, for assuming that the economic slowdown was just over the horizon. If consumers continued to slow down their spending as they had in December, one should expect eventually to see some cut in inventory growth followed by production cutbacks and reduced credit demands. But that had not happened yet. Moreover, the consumer had not been too consistent during the last few months; and with businessmen's behavior influenced unduly by expectational factors rather than by a cold, calculating look at the economic statistics, he thought caution was needed in assuming that a slowdown in credit demand was imminent.

That there had been no dramatic changes in over-all reserve positions despite the churning around of rates and other forces in the money and capital markets was well and good, Mr. Kimbrel continued. A gradual firming rather than a sudden and drastic action was desirable. For that reason he had told the Executive Committee of the Board of Directors at the Atlanta Bank last week that he thought raising the discount rate at this time was inadvisable since it might be interpreted as pushing the panic button rather than an implementation of gradual firming.

The past record showed that there was more danger that the System would be too accommodative rather than too restrictive, Mr. Kimbrel said. Therefore, he hoped that the Committee would not find at its next meeting that substantially more reserves had been supplied than had been intended in connection with the move toward a moderately restrictive policy. He thought there were three possible ways in which that accommodation could occur: the squeeze on the large banks could be relieved by raising the Regulation Q ceilings; the System could become frightened by temporarily high short-term rates into supplying reserves to offset pressures created by expectational and technical factors; and the System could be tempted into supplying all the reserves needed for Treasury financing.

Therefore, Mr. Kimbrel concluded, he could support the staff's draft directive calling for maintaining the prevailing firm conditions in money and short-term credit markets on the understandings that primary attention was to be given to the behavior of the bank credit proxy; that the Desk would not be too disturbed by high short-term bill rates, under the assumption that an increase in the Regulation Q ceilings was to be avoided if at all possible; and that any necessary assistance to Treasury financing would be kept minimal.

Mr. Francis commented that the economy's most serious problem continued to be excessive total spending. Output had been going up as rapidly as labor capacity permitted, and prices had been rising at about a 4 per cent annual rate. The demand for goods and services had been stimulated by a rapid 7 per cent annual rate of growth of M_1 over the past two years, a 10 per cent rate for M_2, and an 11 per cent rate for bank credit.

At its last meeting the Committee had decided to move toward monetary restraint, Mr. Francis noted. As of December 18, discount rates were partially adjusted to market rates, which had been rising rapidly. Those market rates had continued their previous upward movement, although at a decelerated pace. While the period was too short for conclusive analysis, he noted continued net expansion in most monetary aggregates since the last meeting. He saw no net evidence that the System had exercised a restrictive monetary influence. In the week ending January 8 Federal Reserve credit, member bank reserves, and the monetary base all were higher than in the week ending December 18. The money stock was $1 billion higher in the week ending January 1 than two weeks earlier. Even M_2, bank credit at large commercial banks, and the credit proxy had increased in spite of the disintermediation facilitated by Regulation Q. He continued to hope that the growth rates of member bank reserves, the monetary base, and the money supply would soon begin to show solid evidence of slowing.

Mr. Francis felt that for the foreseeable future the System should restrain the growth rates of monetary aggregates even at the cost of still higher interest rates. As a target for the next several months, it would seem desirable for the money stock to increase at no more than a 4 per cent annual rate and at no less than a 2 per cent rate. Temporarily, that might contribute to relatively high interest rates by limiting one source of available funds. As the demand for goods and services and inflationary expectations gradually diminished, however, the huge demand for funds was likely to contract, causing interest rates to move lower.

In evaluating the behavior of monetary aggregates in the near future, Mr. Francis remarked, the Committee should give less weight than usual to commercial bank credit and the measure of money which included time deposits. With the recent increase in market interest rates relative to Regulation Q ceilings, banks would be less successful in acquiring or holding time deposits, particularly large-denomination CD's. As a result, some funds that normally flowed through commercial banks were likely to move directly from source to borrower without passing through a bank. Hence, changes in bank credit and time deposits might be a misleading indicator of total credit expansion in the economy, tending to understate actual growth. The re-directing of funds away from local financial institutions and into the money markets might discriminate against consumers, home buyers, and small businesses, if Regulation Q ceilings remained at present levels.

With market rates substantially higher than the discount rate, Mr. Francis observed, there would probably be a tendency for member banks to do more of their reserve adjusting by borrowing from Reserve Banks. A rise in the volume of those loans outstanding should not be considered as monetary restraint. In fact, the Committee should give quite the opposite interpretation to such a development. Loans outstanding from the Federal Reserve should be considered as substitutes for System holdings of Government securities.

Mr. Robertson made the following statement:

> Since our mid-December meeting, monetary restraint has caught the attention of the country--partly because of the conduct of open market operations, partly because of the discount rate action, but importantly, too, because of the contents of the press announcement of the latter. While, with the benefit of hindsight, I think that the results would have been even better if, instead, we had raised reserve requirements--either alone or in conjunction with the discount rate action--there are clear signs of some dampening effects on particular banks and on some elements in other financial sectors.
>
> But the toughest part of our job lies ahead. That consists of sticking to a tight policy with determination until the economy has been set decisively on the track of a slower and noninflationary expansion. Assuming that we have the wisdom and the courage to stick to our guns, we should be successful eventually--perhaps sooner than most people think--in getting on top of the inflationary problem. We will be receiving plenty of advice to let up on the pressure--from people afraid of the effects of tight money on the banks, on the savings institutions and the housing industry, on the economy in general, and perhaps on some of our closest friends abroad as well. Many of these reasons will sound plausible, I am sure, but I am also sure that any easing up on our part--whether by providing more reserves or by raising Q ceilings--would loosen our restraint on inflationary expectations and reinforce a complacent feeling in some quarters that the Fed will relax its pressures in the pinch and that therefore no cutbacks in financing and spending decisions really have to be made. This is the most pernicious attitude we face, and we have to be very careful not to foster it by being too quick to moderate our restraint.
>
> For now I am in favor of holding as tightly as we can to the firmer conditions introduced since the last meeting. I would urge the Manager to guard against even any temporary easing of the money market, so long as bank credit does not falter so much as to trigger the proviso clause on the downside. And I would like him to be assiduous in activating the proviso clause on the upside.

Beyond attention to the bank credit aggregate as a whole, I think we also need to keep an eye on major movements in the money supply. We may argue about the extent of causal power in the money supply, but its influence as a symbol in the current climate is undeniable. I do not mean to advocate using "money supply" as a primary target for day-to-day open market operations, or as a substitute target for the proviso clause. But I do mean that excessive rates of money supply growth, if persisting, should lead us to consider reinforcing the speed and vigor of our tightening operations.

Finally, if our present restraining posture should prove to be inadequate, we should keep an increase in reserve requirements at the ready. We may very well need to use this kind of an overt System action in order to drive home our basic policy thrust against inflationary credit availability.

Mr. Robertson added that he agreed with those who thought the wording of the policy statement on the balance of payments in the first paragraph of the directive was no longer appropriate in light of the information now available to the Committee. Retention of the present language might leave the impression, when the directive was made public in a few months, that the Committee had been unaware today that there had been a surplus in the payments balance for 1968. He would propose replacing the clause "and attaining reasonable equilibrium in the country's balance of payments" with "and improving the country's balance of payments position."

With respect to the second paragraph of the draft directive, Mr. Robertson thought the word "prevailing" was superfluous in the expression "maintaining the prevailing firm conditions." He also had some question about the form of the references to the Treasury refunding since only part of the forthcoming policy period would be subject to even keel constraints. However, he did not have strong feelings about either of those matters.

Chairman Martin remarked that he would report briefly to the Committee on how he had been discharging his responsibility, as Chairman, for maintaining the System's relations with the outgoing and incoming Administrations during the current period of transition. In recent weeks, he had been in communication by telephone and otherwise with President Johnson and President-elect Nixon and appropriate associates of both. He had informed them prior to mid-December of the general view within the Federal Reserve that the reduction of the discount rate to 5-1/4 per cent in August had turned out to have been based on a miscalculation, and that the rate should shortly be increased to the previous level of 5-1/2 per cent or perhaps to 5-3/4 per cent. He had advised them that in his judgment the choice between an increase of 1/4 and 1/2 point was not crucial, since the primary problem was not one of rate relationships but rather one of dealing with the prevailing inflationary psychology.

The Chairman said he thought the System's relations with the outgoing Administration were ending on a good note and that early contacts with the incoming Administration were proceeding harmoniously. Both he and Mr. Brill had participated to some extent in the recent discussions between the two Administrations on the status of the income tax surcharge, and he personally was gratified at the outcome of those discussions. He had reviewed the structure and workings of the Federal Reserve and the problems it faced with people who would have responsibilities in the economic policy area in the new Administration, and they appeared to have a generally good understanding of the System and a cooperative attitude. To Mr. Nixon he had expressed his view that inflation was the primary economic problem now facing the nation, and that the new Administration would have to deal with it effectively from the beginning if inflation were not to get out of control. He had done his best to emphasize the seriousness of the problem and had left for Mr. Nixon a memorandum on the subject prepared by Mr. Brill.

On the whole, Chairman Martin continued, he thought that from the standpoint of the Federal Reserve the transition was going well, and he was rather optimistic about the System's relations with the new Administration. Continued close relations and policy coordination would be important, particularly since monetary policy would need the help of fiscal policy in coping with inflation.

Turning to the question of current monetary policy, the Chairman remarked that the System continued to face the problem of dealing with the "heritage of errors" from past economic policies. That problem was not new; the System had faced similar difficulties from time to time in the past. It was true that the Federal Reserve had been widely criticized in recent months on the grounds that it had vitiated the effects of fiscal restraint by an unwarranted easing of monetary policy last summer. He did not think such criticism was wholly justified since much of the prevailing inflationary psychology was a consequence of the long delay in getting fiscal legislation. That psychology--which, as Mr. Coombs had noted earlier, was part of a world-wide phenomenon--appeared to have outrun the underlying economic realities since last summer.

In any case, Chairman Martin observed, he thought monetary policy was now on the right track. In his judgment it would be better at this juncture to risk overstaying, rather than understaying, a policy of restraint, and he certainly would not want to relax policy now. The staff's draft directive seemed to him essentially appropriate, although the Committee might want to adopt some of the language changes that had been suggested in the go-around, such as the change Mr. Robertson had proposed in the policy statement on the balance of payments. He had no strong feelings about the proposal to delete the word "real" before "economic activity" in the first sentence, since the word would be implied in any case.

Mr. Maisel remarked that preferences with respect to the form of the balance of payments statement seemed to be a matter of taste. Personally, his reaction was just the reverse of Mr. Robertson's; he thought that the statement of the objective proposed by the latter--in terms of "improving" the balance of payments--would suggest to readers that the Committee had been unaware today that there had been a surplus in 1968. The language of the staff's draft appeared preferable since it was clear that the Government's programs had both produced large inflows and halted other outflows. Therefore, given the existence of those programs, most observers would agree that reasonable equilibrium had not been attained.

Mr. Daane said he also continued to favor the language of the staff's draft. The facts concerning the year-end inflows were set forth in the next-to-last sentence of the first paragraph. Since those inflows did not mean that reasonable equilibrium had been achieved, he saw no reason for changing the statement of the Committee's objective from the form that had been used for some time.

Mr. Brimmer noted that the sentence involved--the last of the first paragraph--differed in content from the preceding sentences. Whereas the bulk of the first paragraph contained a summary description of economic and financial developments, the last sentence specified the Committee's general policy stance and broad objectives. Perhaps it would be desirable to set off that sentence in a separate paragraph. In any case, as he had indicated earlier he favored the staff's draft language.

After further discussion, the Committee decided to accept the language of the staff's draft for the balance of payments statement. It also agreed to retain the word "real" in the statement of the first sentence to the effect that "real economic activity has been moderating." In that connection, Mr. Brill noted that in submitting past directive drafts the staff customarily had used the term "over-all" economic activity as a synonym for "real" activity. Ordinarily, however, the statements in which the term occurred had been accurate whether one had real or dollar-volume GNP in mind. That was not the case now, since there had been a significant decline in real, but not in dollar, GNP growth in the fourth quarter. The staff therefore had proposed the use of the word "real" to avoid possible misunderstanding.

In the discussion of the changes proposed in the draft of the second paragraph, it was agreed that the reference to the Treasury refunding should be deleted from the primary instruction but retained in modified form in the proviso clause. Mr. Mitchell remarked that he would prefer to retain the word "prevailing" in the primary instruction since it served to define the following phrase, "firm conditions in the money and short-term credit markets."

Mr. Hickman said that while he had some sympathy for the substitute language for the proviso clause that Mr. Morris had proposed, he would not favor its adoption since it would involve a change in policy. At the same time, he thought it was desirable not to press monetary restraint so far that it would become necessary to back off. He asked Mr. Holmes how the Desk would react if the bill rate rose to the upper limit of the range given in the blue book--6.25 per cent--and a sharper than expected run-off of CD's ensued.

Mr. Holmes replied that the Desk's reaction would depend mainly on the effect such a development had on the bank credit proxy, assuming the directive contained the two-way proviso shown in the staff's draft. If there were a significant short-fall in bank credit from the projection, the Desk would modify its operations.

Chairman Martin then suggested that the Committee vote on a directive consisting of the staff's draft with the references to the Treasury refunding modified in the manner discussed earlier.

Mr. Morris said he would find it necessary to dissent from such a directive since in his judgment it could be compatible with an unduly restrictive monetary policy. He thought his position today was consistent with the position he had taken at other recent meetings when he had spoken in favor of a substantial slowing in the rate of bank credit growth. As he recalled the discussion at the previous meeting, the Committee had not sought money market conditions that would be compatible with an actual contraction in bank credit.

> With Mr. 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 expansion in real economic activity has been moderating, with slower growth in consumer outlays but higher rates of business inventory accumulation and capital expenditures. Upward pressures on prices and

costs, however, are persisting. Since the mid-December firming of monetary policy, most interest rates have risen further and, with the outstanding volume of large-denomination CD's declining sharply, bank credit expansion has slowed. Growth in the money supply moderated somewhat on average in December from its rapid November pace. The U.S. foreign trade surplus remains very small but near the end of the year unusual capital inflows had a markedly favorable effect on the over-all balance of payments. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining 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 the prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the forthcoming Treasury refunding, if bank credit expansion appears to be deviating significantly from current projections.

It was agreed the next meeting of the Committee would be held on Tuesday, February 4, 1969, at 9:30 a.m.

At this point, all members of the staff withdrew from the meeting except Messrs. Holland, Kenyon, Broida, Hackley, Brill, Axilrod, and Holmes; and Mr. Molony, Assistant Secretary, and Mr. Harris, Coordinator of Defense Planning, Board of Governors, entered the room. Mr. Holmes reported to the Committee with respect to the latest developments in connection with the Government's investigation of the leak of information on the Treasury refunding of August 1967, and in the course of the ensuing discussion he responded to questions.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

January 13, 1969

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on January 14, 1969

The information reviewed at this meeting suggests that expansion in real economic activity has been moderating, with slower growth in consumer outlays but higher rates of business inventory accumulation and capital expenditures. Upward pressures on prices and costs, however, are persisting. Since the mid-December firming of monetary policy, most interest rates have risen further and, with the outstanding volume of large-denomination CD's declining sharply, bank credit expansion has slowed. Growth in the money supply moderated somewhat on average in December from its rapid November pace. The U.S. foreign trade surplus remains very small but near the end of the year unusual capital inflows had a markedly favorable effect on the over-all balance of payments. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

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