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, February 4, 1969, at 9:30 a.m.

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

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

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

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

Mr. Cardon, Assistant to the Board of Governors
Messrs. Coyne and Nichols, Special Assistants to the Board of Governors
Mr. Gramley, 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

Messrs. Hilkert and Helmer, First Vice Presidents of the Federal Reserve Banks of Philadelphia and Chicago, respectively
Messrs. Eastburn, Parthemos, Baughman, Jones, Tow, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Philadelphia, Richmond, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Messrs. Eisenmenger and Green, Vice Presidents of the Federal Reserve Banks of Boston and Dallas, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Messrs. Bodner and Geng, Assistant Vice Presidents, Federal Reserve Bank of New York
Miss Beekel, Assistant Vice President and Economist, Federal Reserve Bank of Cleveland

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on January 14, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on January 14, 1969, was 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 January 14 through 29, 1969, and a supplemental report covering the period January 30 through February 3, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said that the market price of gold had held at about $42.50 in recent days with turnover generally moderate. In the early part of the period since the Committee's previous meeting the price had tended to advance somewhat, reflecting the uncertainties over future U.S. gold policy and the continued tensions in the Middle East. Secretary Kennedy's statement on January 22 had been generally received both at home and abroad as an unequivocal reaffirmation of the U.S. commitment to the $35 official price, although there had been skepticism expressed in some quarters which--not surprisingly, of course--included Switzerland. Under the initial impact of the Secretary's statement the opening quotation for gold on January 23 had been as low as $41.75 but the fixing that day took place at $42.20. Thereafter, trading volume had been small--with prices moving up somewhat--until this week when there had been a brief easing and some increase in volume. This morning the price was $42.47. The situation remained one in which persistent industrial demand and the regular flow of gold to Asia provided good demand while the explosive Middle East situation encouraged many holders to retain their positions. At the same time, however, it should be noted that at the current price level a sufficient supply was being made available from existing hoards to meet the demand and there was no evidence of any current selling by South Africa.

On the exchange markets, Mr. Bodner continued, the past few weeks had been relatively calm, with sterling beginning to show some seasonal strength. The massive outflow of funds from Germany had tapered off for a while, although in the past few days there had been some further outflow. With the relaxation of the squeeze in the Euro-dollar market around the middle of January, sterling began to firm and the Bank of England had been able to take in a few dollars. The spot rate for the pound reached a level of about $2.39 by January 22 and held around that level subsequently. However, despite that advance in the rate, and despite the gains made by the Bank of England earlier in the period, the fact was that the market remained extremely skeptical about the future of sterling and there was no significant demand. Indeed, while the overseas sterling area countries had been building up their balances, the balances of the non-sterling countries--which typically had mirrored the state of confidence--had fallen further in recent weeks. Forward discounts were narrower but remained at levels that discouraged covered inflows of funds to the United Kingdom, while the lack of confidence precluded any but very short-term uncovered inflows. Thus, although the British had been able in January to reduce the volume of their overnight borrowing, they had not been able to make any progress in reducing other commitments. Figures for January released today showed a net increase in British reserves of only $12 million. More fundamentally, with the trade deficit remaining large and consumer spending high, the Bank of England had felt it necessary to reemphasize to the banks the need to cut their lending for non-essential purposes.

There had been no significant change in the underlying position of the French franc in recent weeks, Mr. Bodner observed. The French current-account deficit seemed quite clearly to be reflected in the exchange losses of the Bank of France earlier in the period, while further tightening in some aspects of the exchange controls had once again produced some temporary inflow of funds in recent days. While liberalizing somewhat the rules on the acquisition of forward cover by French importers, the Bank of France had imposed further restraints on the French banks' management of their foreign exchange positions--restraints which were designed to force the deposit of surplus exchange holdings with the Stabilization Fund. Those measures had begun to produce some flow of funds into the Bank of France and the French had used some of the money to reduce their commitments to the System. At the end of January the Bank of France repaid $112 million of their swap drawings, bringing their commitments to the System down to $293 million.

Mr. Bodner noted that Mr. Coombs had observed at the previous meeting of the Committee that it was problematical how long the massive outflow of funds from Germany could continue. In fact, that outflow had tapered off in the last two weeks of January. From January 1 to January 22 the Germans had put out about $1.3 million net, although since the latter date they had been receiving about as much from maturing swaps as they had lost through new spot sales or swaps. The drain on German reserves had actually reached the point at which they were running low on cash and were becoming concerned about the continuation of the losses. Consequently, the German Federal Bank raised its rates on swaps to make them less attractive to the commercial banks, and at the same time it permitted the spot rate to fall well below par. Moreover, the German Federal Bank bought $30 million from the System and $50 million from the U.S. Treasury.

As the Committee was aware, Mr. Bodner continued, the System had used the marks acquired from the German Federal Bank and additional marks purchased in the market to fully liquidate System swap drawings; and yesterday the Treasury used the marks it had acquired from its dollar sale to Germany to pay off a maturing foreign-currency note. At month-end the swap maturities of the German Federal Bank were running ahead of spot sales and consequently they had begun to rebuild their dollar holdings. The Germans had anticipated some further rebuilding of their dollar position as a result of swap maturities this week and next. In the last two days, however, when there had been some tightening in the Euro-dollar market, the Germans had experienced large losses--$130 million yesterday and $170 million today.

Mr. Bodner went on to say that perhaps the only other item of significance in foreign exchange developments in the recent period had been the easing in the Swiss franc as the Swiss banks reestablished their Euro-dollar positions. During the period the Swiss National Bank had begun to intervene once again to supply dollars to the market, and that outflow had provided an opportunity for the System to begin covering its outstanding swap commitments in Swiss francs. So far the System had purchased a total of $100 million equivalent of Swiss francs from the Swiss National Bank and would use those francs on February 6 to make an equivalent reduction in System swap drawings. In addition, arrangements had now been completed for the pay-down of a further $100 million of those commitments through the issue by the Treasury of $75 million in foreign-currency securities and the sale of $25 million in gold.

Those transactions also would be completed on February 6, at which time the System's over-all indebtedness in Swiss francs would be reduced from $320 million to $120 million. The Swiss expected further outflows of funds throughout February, and the Account Management hoped to make further reductions in the swap position in coming weeks.

Mr. Bodner said he would add a few words about developments in the Euro-dollar market, to which he had already referred in passing. As the members knew, Euro-dollar rates had peaked just prior to the previous meeting of the Committee. From about January 13 to January 21 there had been a progressive decline which brought the three-month rate to 7-3/16 per cent while shorter maturities fell even further--the call money rate, for example, fell to 6-5/8 per cent from 8 per cent earlier in the month. That decline coincided with reduced--although still very substantial--takings by U.S. banks, continued large outflows from Germany, and smaller outflows from the Belgian, French, and Swiss central banks. In the latter part of January, however, rates began moving up again. That rise followed a firming in U.S. interest rates at the same time that the outflow from Germany tapered off, the Belgian franc strengthened, and both the French and British began taking in funds. In the past few days rates had continued to advance, especially at the shorter end of the maturity range; at present, call money was at 7-1/2 per cent and the three-month rate was 7-13/16 per cent. U.S. bank branches evidently were not significantly increasing their borrowings, but they were bidding strongly simply to maintain their present positions, while the Italians also were now bidding for funds.

In reply to a question by Mr. Brimmer, Mr. Bodner said it was difficult to make any firm judgments about the availability of Euro-dollars during the next month or two. The Swiss probably would be supplying funds to the market in February. It had been expected that the Germans would be withdrawing funds, but developments during the past two days made that look less likely and there might in fact be further outflows from Germany. On the whole, he thought the flows of Euro-dollars would be reduced from the very large volume of the last four weeks. With respect to Euro-dollar rates, he certainly would not expect any significant easing, and there might be some further firming.

Mr. Mitchell noted that U.S. bank liabilities to their foreign branches had declined by about $1.4 billion in the last three weeks of December, but had risen in January to a level about $1.2 billion above the peak prior to the December run-off. He asked whether Mr. Bodner thought it was likely that U.S. banks would be able to acquire as much as an additional $1 billion of Euro-dollars during the next month.

Mr. Bodner replied that he would be surprised if the volume of Euro-dollar inflows was that high. While he was not prepared to estimate the probable flows, it seemed clear to him that U.S. banks would have to pay high rates simply to maintain the present level of their Euro-dollar liabilities.

Mr. Brimmer asked whether the Swiss were likely to become increasingly interested in supplying funds to the Euro-dollar market if rates advanced there.

Mr. Bodner responded that they probably would become somewhat more interested in that event. However, he doubted that any additions to the supplies of Euro-dollars from Switzerland would be very large, since a substantial part of the funds available to the Swiss for the purpose were already invested in the Euro-dollar market.

Mr. Hickman asked whether increases in Euro-dollar rates--resulting, say, from continuing demands by U.S. banks in the face of reduced supplies--would not have important effects on rates in domestic money markets in Europe.

Mr. Bodner replied affirmatively. He noted that rising Euro-dollar rates tend initially to push up the forward exchange rates for other currencies. In recent weeks, however, when the German Federal Bank had been supplying forward marks relatively cheaply there had been large outflows from Germany into Euro-dollars and fairly significant increases in German domestic interest rates. Swiss rates, too, had risen.

> By unanimous vote, the System open market transactions in foreign currencies during the period January 14 through February 3, 1969, were approved, ratified, and confirmed.

Mr. Bodner then noted that a System drawing--originally in the amount of $200 million--on the Swiss National Bank would mature for the first time on February 27. The swap repayments that he had mentioned earlier covered not only the $120 million in maturities that Mr. Coombs had discussed at the last meeting but also $80 million of the drawing in question, so that the balance outstanding on the latter was only $120 million. As he had indicated, further reduction in that commitment was expected before February 27, but he would recommend renewal of the drawing for a second three-month term if necessary.

> Renewal of the System drawing on the Swiss National Bank was noted without objection.

Mr. Bodner observed that there were no other System swap commitments falling due in the coming period, but swap drawings by the Bank of France, the Bank of England, and the Belgian National Bank would be maturing. The Bank of France had three drawings, totaling $260 million, that would mature for the first time in the period February 18-20. As he had indicated, the Bank of France had made further progress in reducing its swap commitments but, in the event that it requested renewal of the drawings in question, he would recommend approval. The Bank of England had seven drawings, totaling $850 million, that would mature for the first time in the period February 18 to March 11. In addition, there were two Bank of England drawings of $50 million each that would mature for the second time on March 5 and March 10, respectively. He would recommend renewal of all nine drawings if requested by the Bank of England. Finally, on February 25 a $2 million drawing by the National Bank of Belgium would mature for the first time, and he would recommend renewal if requested by the Belgians.

Renewal of the drawings by the Bank of France, Bank of England, and Belgian National Bank 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 January 14 through 29, 1969, and a supplemental report covering January 30 through February 3, 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:

During the period since the Committee last met market psychology was subjected to a variety of influences. Early in the period there was a reaction to the extreme gloom that prevailed in December, partly reflecting the seasonal improvement in the position of the money market banks and the greater availability of Euro-dollars and partly reflecting an improvement in market attitudes as prospects for the Vietnam peace talks and the budget improved. But as the period progressed, steady pressure on the banks through open market operations and the continued CD attrition resulted in greater market uncertainty. Fears of a credit crunch appear to have subsided on balance, but the period of relative euphoria apparent a week or so ago appears also to have subsided. There again seems to be a growing conviction in the market that the Federal Reserve and the Treasury are determined to resist inflation. There are many in the market who now expect further action on the part of the System as soon as the Treasury refunding is out of the way. A fair degree of skepticism about the System's willingness to keep up the pressure exists, based in part on misinterpretation of some of the money supply figures that appeared earlier in January. Certainly, not many of the large banks have felt constrained to make major changes in their lending policies, although some spotty tightening is apparent. The fact that banks have not made further adjustments reflects in part the seasonal absence of strong demand. As seasonal factors shift, however, continuation of the present degree of System pressure on the banking system will inevitably have an effect on attitudes and on markets as the basic reserve position of the money market banks is reversed in the weeks ahead.

Interest rate developments largely reflected the changes in market psychology over the period and special supply-demand situations. Short-term interest rates declined quite sharply early in the period, with the three-month Treasury bill rate falling to as low as 6.04 per cent about the middle of the month. Any hope that a continued decline would make it possible for the banks to avoid continued CD attrition was soon dispelled, however, with rates moving back to about the levels prevailing at the time of the last meeting. In yesterday's regular auction of three- and six-month Treasury bills, average rates of 6.25 and 6.36 per cent, respectively, were established, little changed from the rates established in the auction just before the last meeting of the Committee.

In the long-term markets there was, during the period, some hopeful talk about interest rates peaking out based on the new Administration's apparent concern with inflation, budget and Vietnam developments, the absence of large-scale commercial bank liquidation of municipal securities, and an undercurrent of feeling that the Federal Reserve would pull back from restraint as soon as any signs of hesitation in the economy appeared. By the close of the period, however, there was a far less optimistic attitude prevalent. The municipal market particularly showed signs of strain, as commercial bank buying contracted. New issues were poorly received despite new high yield levels. Corporate bond yields also moved to record levels.

The improvement in the basic reserve position of the major money market banks has been amply commented on in the written reports to the Committee. In addition to the usual seasonal movements of deposit flows, the increased availability of Euro-dollars appears to have been a major factor in this development. The source of Euro-dollars appears to have been a combination of the return to deficit in January of our balance of payments and successful efforts by the German Federal Bank to encourage a short-term capital outflow from Germany. Both of these developments appear to have had a widespread impact on the banking system as net payments on balance of payments account moved deposits from domestic to foreign accounts and as domestic investors had to pay for the Treasury bills sold by the German Federal Bank. These funds were then channeled through the Euro-dollar market to the largest banks, with an actual basic reserve surplus developing in New York City banks last week and a record level of borrowing by country banks. These twin developments had the result of taking some of the pressure off the Federal funds market as the most aggressive bidders had less urgent needs and country banks made greater use of the discount window. This in turn helps explain last week's anomaly of the highest level of net borrowed reserves in 16 years and a relatively comfortable Federal funds market.

As far as open market operations are concerned, the System maintained steady pressure and this involved the absorption of the seasonal reflux of reserves to the banking System. Extensive use of matched sale-purchase agreements was made, and outright market sales of Treasury bills provided a useful signal to the market at a time when the Treasury bill rate was under downward pressure. As you know, the credit proxy, adjusted for Euro-dollars, appears to have declined at about a 2 per cent rate in January, a somewhat weaker performance than had been anticipated at the time of the last meeting. Nonetheless, given the relatively comfortable position of the money market and the continued market skepticism about the System's intentions, no effort was made to implement the proviso clause of the directive on the side of somewhat less restraint. For February the projection is for a further decline in the proxy, in a zero to minus 3 per cent range after allowance for the maintenance of Euro-dollar borrowings at the expanded January level. As usual, it would be most helpful to have the views of Committee members as to their interpretation of the suggested proviso clause of the directive.[1/]

Books on the Treasury refunding of $14.5 billion Government securities maturing February 15 will close tomorrow night. The announcement last Wednesday that the Treasury would offer, in exchange for the maturing securities, a 15-month 6-3/8 per cent note priced to yield 6.42 per cent and a 6-1/4 per cent 7-year note priced to yield 6.29 per cent failed to generate much market enthusiasm. This was so despite the fact that the Treasury is offering the highest return in over a century and despite the judgment of most market participants that the issues were fairly priced. While the offering has not generated much market activity and the maturing issues have little or no "rights" value, many market observers expect that the high coupons will draw a fair response from holders of the maturing issues. Attrition, however, is expected to be considerably greater than the normal 10 per cent. The degree of market uncertainty is likely to restrain dealer participation in the financing and there appears to be

1/ The draft directive submitted by the staff for consideration by the Committee is appended to this memorandum as Attachment A.

little danger of any speculative interest in the issues. While any deepening of market uncertainty could turn the financing quite sour, the outlook is for a moderate extension of debt, with some observers expecting subscriptions for the 7-year note to center around $1 billion to $1-1/2 billion and attrition in about the same range. On this basis I would expect to enter subscriptions for about one-third of the System's holdings of about $8-1/2 billion maturing securities for the 7-year note and the balance for the 15-month note, but we may get a more accurate picture of market expectations by tomorrow.

There is little to add to my memorandum to the Committee on the Treasury's cash and debt ceiling problem.1/ Since then there has been an improvement in the Treasury cash flow, which--if it is sustained--reduces the likelihood that the Treasury would have to resort to the warehousing proposal. The improvement is neither large enough nor sure enough, however, to eliminate the Treasury's desire to have a back-stop facility available.

I might make a final comment about the apparent anomaly between the expected budget surpluses for fiscal 1969 and 1970 and concern about the debt ceiling between now and April and again in the autumn. The consolidated budget surpluses arise from the sizable surpluses of the trust funds. Such surpluses, unlike an improvement in tax receipts relative to spending, involve an increase in debt subject to ceiling as the Treasury issues non-marketable debt to the trust accounts. There is little question that a change in the debt ceiling will be required, but the question of timing of the Treasury approach to Congress remains a complicated one.

1/ This memorandum, entitled "Treasury cash and debt ceiling dilemma," and dated January 30, 1969, was distributed to the Committee on that date. Two related memoranda were distributed subsequently. These were from the Committee's General Counsel, entitled "Legal aspects of proposals for assisting Treasury in connection with cash and debt ceiling problems," and dated January 31, 1969; and from the Secretariat, entitled "Additional material *re* the Treasury debt ceiling problem," and dated February 3, 1969. Copies of these memoranda have been placed in the Committee's files.

Mr. Daane asked whether the debt ceiling problem could be relieved at this time by Treasury redemptions of special issues held by the trust funds and investment of the proceeds in outstanding marketable issues.

Mr. Holmes replied that the Treasury might be able to redeem some special issues. However, its flexibility in that connection was quite limited at present since it faced the problem of a low cash position in addition to that of the debt ceiling, and investments by the trust funds in marketable issues would, of course, reduce the Treasury's cash balance. It might be feasible, however, to use that approach in the fall to help meet the debt ceiling problem anticipated then.

Mr. Brimmer asked whether there were any techniques available to the desk to take explicit account of Euro-dollar inflows, or whether the Desk necessarily looked only to the total availability of reserves in its operations. He was concerned that access to the Euro-dollar market might leave a few large banks relatively free of the impact of monetary restraint.

Mr. Holmes replied that the Desk had no selective means of influencing the behavior of banks that could draw funds from the Euro-dollar market. However, the Desk recognized that Euro-dollar flows could have an important influence on total bank credit, and they were taken into consideration in connection with the proviso clause of the directive. As he had noted, the recent relatively comfortable position of major money market banks had resulted largely from seasonal influences which had tended to redistribute reserves from country to money market banks, and those seasonal influences were expected to be reversed soon.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 14 through February 3, 1969, were approved, ratified, and confirmed.

The Chairman then called for the staff economic and financial reports, supplementing the written reports, statistical tables, and charts that had been distributed prior to the meeting. Copies of these materials have been placed in the files of the Committee.

Mr. Brill made the following introductory remarks for today's staff presentation:

> Our presentation this morning departs from precedent in several respects. It has been the custom, you will recall, for the staff to present a chart show at this time of year describing and evaluating the economic model underlying the Budget of the United States, and outlining the monetary policy that would be consistent with it. We will not be presenting such a chart show today. First, because of the hassle on continuation of the surtax, the budget model became available much too late to permit the luxury of a full-fledged chart show. But more importantly, there is serious question in our mind as to whether the official model represents either an appropriate target for monetary policy this

year or an accurate evaluation of the prospective strength of upward price pressures. It is not the staff's function to set policy targets, of course, but we would be somewhat less than sensitive to the substance of discussion around this table if we were to burden the Committee with policy strategies leading to an economy in which a rapid rate of inflation persists, just as it would be a waste of your time and of staff resources for us to describe strategies bound to produce a serious recession and a high rate of unemployment.

But these boundaries leave a wide range of possible price and employment trend combinations. The official model describes an economy closer to one end of the range of combinations; as we diagnose their model, price pressures would remain strong, and unemployment would edge up very slowly. As an alternative, the staff has prepared another projection, using the same fiscal policy assumptions as in the official model, but incorporating a somewhat more restrictive monetary policy assumption that--if our calculations are in the ball park--would produce a gradual but persisting deceleration in prices, at the cost of a somewhat faster rise to a somewhat higher rate of unemployment.

Let me summarize the official model briefly; more details--some of them imputed to the Council of Economic Advisers by us--are provided in the materials distributed this morning. Over the first and second quarters of this year, the economy described in the official model does not look a great deal different from our projection. The pace of economic activity slows down markedly in this period, with growth in real GNP dropping to a little more than a 1 per cent annual rate in the spring quarter, compared with the 1.5 per cent rate in our projection.

But the CEA model bounces back sharply after mid-year, spurred by the Federal pay raise, the end to the retroactive payments on the surcharge, and a monetary policy that is significantly easier than the one in effect recently or that we are postulating by our exercise. Perhaps the best index to the relative degree of monetary restraint is the pattern of housing starts embodied in a projection. In the CEA model, housing starts flatten out in the first half of this year, then begin to edge up, to average over 1.6 million in the final quarter.

It is our rough calculation that this degree of strength in the housing area would require credit market conditions to return to the levels prevailing last fall, with bill rates perhaps centering around 5-1/2 per cent and fund flows to thrift institutions--and to banks, which were such an important element in the mortgage picture last year--recovering significantly from the recently reduced volume. And these conditions would have to be achieved soon, so that the spring building season could get under way relatively unimpaired.

The strength of housing in the Council's model, and the renewed vigor in consumption, along with easier credit conditions, induce businessmen to maintain a fairly strong pace of inventory accumulation and new plant investment in the third and fourth quarters. Over all, the economy moves back to a 4 per cent real growth rate, but happily, the recovery is not marred by resurgence in inflation. The GNP price deflator, which drops sharply over this half year, levels off at a rate of about 3 per cent after mid-year.

Our reservations about this model rest on our skepticism that two quarters of reduced real growth will be enough to remove so much of the inflationary heat stored up in an economy that has moved at an excessive pace for so long. We, too, anticipate some easing in the rate of price advance this spring, but far less than does the CEA. And we doubt that the 3 per cent rate in the deflator could be held if the economy bounces back rapidly to a 4 per cent real growth rate. The rebound in prices in the second half of 1967 is a reminder that inflationary pressures break out swiftly in a period of resurging demands that follows a brief period of price stability achieved by pinching profit margins.

Critical in our projection is an objective of limiting the potential rebound in activity in the second half of the year, when the impact of fiscal restraint is scheduled to be less severe than in the first half. This, then, calls for monetary conditions in the first half a significant order of magnitude more restrictive than those underlying the CEA projection.

A more detailed description of the financial conditions we have in mind will come later in our presentation.

Mr. Partee then presented the following description of the real economy which the staff saw emerging over the course of 1969 under the conditions of monetary restraint postulated.

Recent evidence continues to suggest some slowing in the earlier excessive pace of economic expansion. True, weekly sales reports indicate a snap-back in retail trade from the depressed pre-Christmas level, but this had been anticipated. Perhaps more importantly, unit sales of domestic autos in January declined further, and scattered announcements of production cutbacks in this and some other consumer lines have begun to appear. Though complete figures are not yet available, the December inventory increase apparently was very large; taking this in conjunction with a downward drift in the real volume of sales and a leveling in manufacturers' new orders, it appears likely that efforts to adjust inventories will tend increasingly to slow production in the months ahead.

Accordingly, our GNP projection continues to call for further reduction in over-all economic expansion during the first and second quarters. The most important factor in this cooling off, as in earlier projections, is an expected leveling off and then decline in inventory accumulation and a marked shift in the budget into substantial surplus. Final sales should continue to expand at about the reduced $14 billion fourth-quarter rate, reflecting some rebound in consumer spending from the exceptionally low fourth-quarter gain, continued though diminishing strength in business investment, and the topping out of housing starts in the current quarter. Real growth in the economy is expected to drop more sharply than growth in dollar expenditures, given the probability of continued sizable price increases, and by the second quarter is expected to be down to a 1-1/2 per cent annual rate.

For the last half of the year, the course of GNP that we have projected depends importantly on the assumption of continuing and increasingly effective monetary restraint. Around mid-year, the impact of fiscal policy will become more stimulative, and could well launch the economy on an accelerated uptrend again unless the forces of expansion are contained by monetary policy. The offsets that we see are the possibilities of inducing a decline in residential construction, a tapering off in business fixed investment outlays, and a reduction in inventory accumulation to very moderate rates. Given sufficient restraint, we calculate that GNP growth might be held to around $13 billion in each of the last two quarters, with real growth tending moderately upward as inflationary pressures diminish.

This GNP outcome assumes that the surcharge will be maintained at least through calendar 1969. But even so, fiscal restraint will diminish abruptly after mid-year. The bulk of the rise in Federal expenditures in the third quarter is due to increases in military and civilian pay, estimated at $2.8 billion at an annual rate. Excluding the pay raise, defense outlays are expected to continue on a plateau, with reductions in Vietnam spending offset by increases on other military programs. Nondefense expenditures also rise somewhat more rapidly in the last half of the year because of the removal of some budget controls and a step-up in the growth of transfer payments and grants-in-aid to States.

In contrast to the somewhat faster rise in Federal expenditures shown in the Budget for the last half of the year, we expect receipts to stay on a plateau for several quarters, even though the surcharge is maintained. This reflects the ending of retroactive payments, together with the projected slowdown in personal income and corporate profits. Consequently, the NIA budget, which is expected to show a sharp spurt toward surplus in the first half of the year, should move to a small deficit in the second.

The impact of the surtax on disposable income was appreciable in the last half of 1968. Gains in income should continue to be limited in the first half of this year as a result of higher tax payments and the anticipated slowing in economic growth. Therefore, we expect that growth in consumer expenditures will continue relatively moderate, despite the prospect of some rebound this quarter. The rise that we have projected in consumer expenditures would likely require a decline in the saving rate to a 6.2 per cent average in the first half, well below the fourth-quarter rate. A drop of this magnitude does not seem unreasonable, assuming that the fourth-quarter rise in the saving rate was due mainly to special factors--such as the flu epidemic--and that the saving rate will fall in keeping with the slower growth in disposable income.

In the third quarter of 1969, however, the projected spurt in disposable income provides the potential for a renewal of strong consumer buying. To some extent, the abrupt upward adjustment in income should be neutralized by a rebound in the saving rate, but we are also depending importantly on the success of restrictive monetary policy in altering business expectations and spending decisions. If this can be accomplished, slower growth of nonconsumption demands should act to dampen aggregate demand and to offset the latent strength in consumer markets.

Higher mortgage interest rates, a reduction in the flow of loanable funds through banks and other depository institutions, and an anticipated curtailment in the volume of new mortgage commitments should bring down housing starts before too long. Perhaps the drop in December was a harbinger of things to come, but we are inclined, as of now, to regard it as a temporary dip. In fact, we are projecting a modest further increase in starts in the first quarter to an annual rate of 1.6 million. By the second quarter, however, starts are expected to be trending down, and a continued fall-off is projected in the second half, to an annual rate averaging 1.35 million. The decline projected is much smaller than in 1966, when the financial crunch reduced housing starts by a third. But given the strong underlying demands for housing, the pronounced swing in emphasis to apartment construction and the very low rental vacancy picture, it will require substantial pressure on mortgage markets even to bring about a decline of the size projected. Residential construction expenditures, of course, will follow a similar pattern, although the drop in dollar outlays will lag behind and be less sharp than that in starts.

The current surge of investment in plant and equipment in the face of a relatively low rate of capacity utilization would appear to reflect considerable business optimism about the course of the economy in the near term. Expectations of furture growth in sales, concern about rapidly rising prices, and the need to offset some of the increasing pressures from labor costs--all combine to support a continued uptrend in investment outlays. A year-end survey of businessmen's anticipations indicates that they had not begun to make changes in their spending decisions, but this did not yet reflect reactions to the recent shift toward tighter money. Once the uptrend in production flattens out, declining capacity utilization rates and lower profit margins, together with credit restraint, should tend to dampen optimism. Therefore, we anticipate a marked slowing in the plant and equipment surge by about mid-year. Although expenditures are projected to rise 10 per cent for the year as a whole, there is not much further dollar growth--and probably some decline in real terms--beyond the first quarter.

We are also optimistic about the prospects for cooling off investment in inventories, given our assumptions about holding growth of final demands in check. We should get some help here from the imbalances which already have developed between output and consumption. But exactly when accumulating stocks will begin to outrun businessmen's confidence in the prospects for higher sales and further price increases is problematical. The easing of sales in the fourth quarter may have laid the base for a questioning of earlier rosy forecasts, but production so far seems to be continuing at a brisk pace in most sectors, and our projection calls for inventory accumulation in the current quarter at close to the relatively high fourth-quarter rate. By early spring, however, we think that downward production adjustments to temper the inventory buildup should become more general. With only moderate further growth in demands anticipated in the second half, as well as the greater cost and difficulty of holding large stocks when funds are tight, the rate of inventory accumulation is projected to decline somewhat further.

As growth of real output moderates over the quarters ahead, the pressure on both physical and manpower resources should gradually abate. The rate of capacity utilization in manufacturing is expected to fall to not much more than 80 per cent by the end of the year, reflecting both the slowing of growth in industrial production and continuing large additions to manufacturing capacity. At the same time, employment gains are likely to fall short of net additions to the labor force in 1969. The adjustment is expected to occur mainly in manufacturing, where cutbacks in workweeks are likely to be followed by hiring freezes and layoffs, once it becomes clear that prospects for further growth in product demand are not so ebullient. The uptrend in employment in nonindustrial sectors will undoubtedly persist, but probably at a slower pace than in the last several years. As a result, the unemployment rate is projected to rise gradually from below 3-1/2 per cent in the fourth quarter of 1968 to about 4-1/4 per cent by the last quarter of 1969.

The upward pressure on wage levels would abate somewhat in 1969 if this projection is realized, as labor markets ease. Key factors here include a sharp reduction in the number of workers covered under collective bargaining agreements up for renegotiation this year, the smaller second- and third-year wage increases under earlier settlements, and the smaller and less pervasive increase in the minimum wage scheduled for this year. However, the effect on costs is likely to be offset in large part by a slowing in productivity gains as output growth slackens. Thus, the increase in unit labor costs is projected to continue at close to the recent 4 per cent rate during the first half of 1969, then edging down to around a 3 per cent rate of increase by the fourth quarter as demands moderate.

With labor and other costs continuing to climb and business demands very strong, industrial prices have been moving up at a fast pace. But if the slowing in growth in the economy shown in our projections is achieved, then the rise in industrial prices should also slow, especially in the latter part of the year after upward wage pressures have begun to ease and business expectations and spending plans have lost some of their steam. The sharp consumer price gains witnessed during most of last year also seem likely to moderate in 1969. Prospects are for some slowing in consumer product price advances in response to smaller increases in industrial prices, although service prices seem certain to continue climbing at a fast pace--around a 6 per cent annual rate--for some time to come.

On balance, if we can continue to make headway in slowing excessive rates of expansion in GNP, the rise in the over-all price deflator might be expected to diminish. We are hoping for a steady downward progression in the deflator, allowing for the third-quarter Federal pay raise, to something less than 3 per cent by the end of 1969.

Mr. Brill continued the presentation with a description of the financial market conditions and the policy assumptions which the staff felt to be consistent with the projections for the real economy, as follows:

The nonfinancial economy just described by Mr. Partee is one in which, hopefully at least, stabilization policies succeed in cooling off inflationary expectations relatively soon, with fiscal restraint biting into the economy in this half year, increasingly reinforced by a degree of monetary restraint which prevents too fast a rebound in the economy in the second half. Accomplishing all this will not be easy, given the length of time we have been running with overheated conditions, and given the technical problems involved in maintaining the appropriate degree of financial restraint this spring.

We are currently experiencing a substantial swing in Federal borrowing requirements--from an annual borrowing rate of over $15 billion in the last half of 1968 to debt repayment at a $2 billion annual rate this half year. A large part of this change reflects the movement of the budget into surplus, but movements in the Treasury's cash balance also are involved. The big increase in Treasury cash in the last half of 1968 is not expected to be repeated.

Repayment of Treasury debt will be exerting downward pressures on short-term market rates, especially after mid-March, and monetary policy will have to lean against these pressures if we are to reduce the public's incentives to switch back into bank deposits--especially CD's; this is essential to success in keeping down the rate of bank credit growth. Private credit expansion is also expected to recede a little in the first half--but this is a reflection partly of the assumed effects of monetary restraint in reducing the growth rate of mortgage borrowing at banks and the volume of State and local government security issues. By the second half, we expect a slowing in the pace of economic activity to reduce private credit expansion further, but Federal borrowing should then be increasing enough to bring the total of funds raised up a little.

The projected effects of monetary restraint on private credit expansion include a decline in total borrowing by businesses and households taken together, despite continued high needs for credit. For example, even though the rate of inventory investment is expected to decline, business needs for external financing will be sustained in the first half by large tax payments and rising plant outlays at a time when profits are being pinched. And consumer demands for housing credit should remain intense.

But the very essence of monetary restraint is to prevent some of these credit demands from being satisfied. Given the degree of restraint assumed, businesses and consumers should have to dig further into their liquid assets to realize spending plans, and--more importantly--to trim these plans in areas heavily dependent on credit availability. The ratio of borrowing to net investment, in our projection, falls below 90 per cent during the current half year, the lowest we have seen since the last half of 1966. The ratio then levels off in the second half, with a further decline in borrowing paralleling a reduction in net investment.

It would take a taut policy to obtain these results, given the underlying strength of expansive forces in the private sector, particularly in the second half of the year when the impact of fiscal restraint wanes. Translating our target GNP projection into financial flows and interest rates, we find that it would involve limiting bank credit growth to an annual rate averaging about 5-1/2 per cent from March onward, following an expected slight contraction in the credit proxy in January and February taken together. These projected growth rates of bank credit would mean that the banking system would be supplying only about one-fifth of total funds raised in the first half of this year--and only a little more in the second.

While this policy would properly be characterized as taut, it is not one that requires additional pressure by the System beyond that being exerted now. On the contrary, CD runoff is now so rapid--the decline was nearly $2 billion in January and we are projecting another $1-1/4 billion or so in February--that unless something is done soon to moderate the CD outflow, we could find ourselves in another 1966-style crunch.

Among the hazards of going too far is the possibility that a crunch and its immediate aftermath would be seized on as an excuse for not extending the surcharge. Extension of the surcharge is not, to my mind, in the bag; the new Administration's endorsement of it has been lukewarm, and it is hard to detect much enthusiasm for it in the halls of Congress. But just because it is not in the bag, we dare not ease up too soon or too much.

Given the dangers of overdoing restraint, but also the dangers of failing to get enough, it seems to us that the appropriate policy would be one of firm, steady, and consistent pressure on the banking system, avoiding either any sudden jamming on of the brakes or any unintentional easing up. There are a number of packages of policy measures which might accomplish this. Intensifying restraint to raise short-term rates further--accompanied by an increase in Regulation Q ceilings to moderate the CD hemorrhage--would be one combination worth considering. Such a combination could have unwanted side effects, however; the boost this would give to short-term interest rates could have a more-than-desirable impact on thrift institutions. Moreover, many in the financial community mistakenly regard an increase in ceiling rates as an easing, rather than a tightening action.

Perhaps a safer package is a combination of open market operations and/or reserve requirement changes aimed at keeping bill rates averaging close to but a shade below present CD ceiling rates.

What we are assuming in this regard is bill rates a shade below the 6 per cent ceiling on 3-6 month CD's. Somewhere within the projected range, we estimate, the attrition rate on CD's should decline to around $250 million a month, or thereabouts. If such a decline continued for an extended period, the large banks would find themselves forced to stiffen lending policies as well as to sell liquid assets. But the rate of decline we are projecting would be much less than in January--or that projected for February at existing rate levels--and it would not seem large enough to generate panicky reactions.

Of course, bill rates would have to come down a little from current levels to get this outcome, but the System would not have to take overt action to get them there. As I noted earlier, the problem this spring will probably not be that of holding short rates down, but of keeping them from falling too far. What the System would need to do, once the present even-keel period is over, is to lean against the wind just enough to keep three-month bill rates from falling below the projected level during a period of large Federal debt repayment. Perhaps, at that time, reserve absorption through a reserve requirement increase would combine desirable flow and psychological impacts, but additional actions might be needed to stem too large or too rapid declines in the short-term interest rate complex.

There are obvious pitfalls in this course of action. The response to fluctuations in the spread between market rates and CD ceilings is neither smooth nor easily predictable; at times a shade of difference can trigger large inflows to or outflows from banks. We would have to be prepared to vary the intensity of restraint on bank reserve positions rapidly to keep the degree of tautness needed. There will be misses, of course, but if the general direction of policy is maintained, and increasingly appreciated by the market, the effects should be observable in all credit markets.

For example, we would expect this policy to push up key long-term rates. The intensification of loan rationing at banks is expected to force businesses increasingly into the bond and commercial paper markets, and thus lead to a rise of 1/4 of a percentage point or more in the corporate new issue rate. For mortgages, the strength of underlying housing demands pressing against a limited supply of funds is likely to produce mortgage rates shading upward from 8 per cent. At these levels, credit costs as well as availability should help to curb spending--not everyone, presumably, expects the current pace of inflation to last for the next 25 years.

The reduction in mortgage credit availability will come partly from reduced inflows to the nonbank intermediaries. A credit policy as stringent as that recommended will not leave the nonbank intermediaries untouched, even though bill rates do decline a little from current levels. Inflows to these institutions were curbed in December and January, and we think they will stay at the reduced volume. The projected growth rates--around 5 per cent--are only a little above the amounts that result from interest crediting. With essentially no new money flowing in, these institutions will have to cut their new mortgage commitments, more likely sooner than later. The mortgage market will also feel the pressure arising from the curtailment of fund availability from commercial banks.

In the banking system, the effect of restraint is likely to show up mainly in time deposits rather than in demand balances and the money stock. For time deposits, the projected descent from the high growth rate in the second half of 1968 is steep indeed. Much of it relates to the decline in CD's discussed earlier. For household deposits, we are projecting a decline to about a 9 per cent annual growth rate. This is less than the rate in the latter half of 1968, when market rates averaged lower than those projected, and seems consistent with rates of growth that appear to have occurred during January.

We do expect, however, some slowing in the rate of expansion in the money stock--in part because the interest rate levels projected will help to induce some further economization of cash, but also because GNP growth (and hence transactions demand) is projected to moderate. Our projected GNP growth path and interest rate assumptions are probably consistent with an expansion of the money stock at roughly a 5 per cent annual rate during the first half of the year, and at about a 4 per cent rate during the second.

To summarize, the monetary restraint pictured here is substantial, particularly in light of the downward rate pressures expected to emerge in money markets this spring, although it stops short of putting the banking system through the wringer. By keeping banks alive but on a short tether, it would prevent a rapid buildup in liquidity this spring that could fuel too vigorous a rebound in economic activity after mid-year. In holding down the rate of expansion below potential for several quarters, it would provide time for some of the factors tending to cool off price pressures to work. It is a dangerous course, for a slowing economy can stall, and we will have to be especially alert to any signs that this may be developing. Nevertheless, it seems to us that the risk is worth taking, for both domestic and international reasons.

Mr. Hersey concluded the presentation with a discussion of the implications of the projected nonfinancial and financial developments for the balance of payments, as follows:

The U.S. balance of payments in 1969 looks tolerable, as Mr. Solomon said here three weeks ago, "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." What we want to give you now is first, an outline of one possible structure of the 1969 balance of payments, and second, a sense of the precariousness of its tolerableness. Certainly we are very far from anything that could be called a reasonable equilibrium in the country's balance of payments.

I shall try to spell out explicitly a number of relevant assumptions as we go on. The first assumption, which is contained in the domestic GNP projection, is that there will be a gradual dissipation of the present widespread expectations of inflation in the United States and a gradual slowing of the inflation itself. So far as the balance of payments is concerned, the lasting payoff via price relationships comes only later. Statistical indexes of export unit values for the United States, Germany, and Japan clearly illustrate the need for making a new start toward checking the deterioration that has been going on since 1965 in our costs and prices compared with those of some of our dynamic rivals in world trade. Of course there is no hope of rolling prices back.

Over the past several years U.S. nonagricultural exports have risen about in line with total world exports of manufactures, and our percentage share has not changed significantly. This performance is creditable so far as it goes, though in the light of U.S. propensities to import goods and invest abroad it is grossly inadequate. Our second main assumption today is that continental European economic activity will continue to rise strongly this year, helping to ensure an advance in the value of U.S. merchandise exports by 8-1/2 per cent--nearly $3 billion annual rate--from the second half of last year to the second half of 1969.

Our third major assumption relates to imports, and has two parts. First, the underlying trend of U.S. imports--a major cause of the world payments disequilibrium--will remain strongly upward, for this can be modified only slowly by cost and price developments. Second, last year's swing above trend will be followed by a dip below trend this year, as happened in the 1967 mini-recession. Imports of materials may decline, but we are not projecting an absolute decline in the total in 1969, only a slowing of the increase to 3 per cent between second half-years, or about $1 billion annual rate. For the year's trade surplus we project something under $2 billion in 1969, compared with about $100 million last year.

When we add in flows of services, investment income, and military expenditures abroad, net exports of goods and services may be over $4 billion this year, compared with \$2.1 billion in the year 1968 and a \$2.3 billion rate in the second half. High U.S. interest rates will enlarge the rise in interest payments to foreigners, offsetting much of the gain in income receipts. While growth in payments for transportation may be below normal in a year of slow import expansion, and while a renewed acceleration in receipts from foreign travel in the United States may occur, these and other services will add little on balance to the improvement in net exports. As for military expenditures abroad, they are projected as leveling off now, and then dipping slightly later this year, but on the other side of the account military export sales also are passing their peak.

Outflows of U.S. private capital are projected for 1969 at about the rate of the second half of 1968. Here we have several additional assumptions. We assume that the direct investment control program will remain in effect, preventing corporations from retiring any significant part of the foreign debts created in recent years to finance direct investment. We assume that the interest equalization tax will be renewed with a tax rate high enough to restrain unregulated U.S. investors from large-scale buying of the American company Euro-bonds and convertible debentures that are subject to I.E.T. or of outstanding European securities, as well as to prevent new issues here of foreign securities other than the exempted issues of Canada, Israel, international institutions, and a scattering of others. And we assume that the VFCR will remain in effect. The I.E.T. and the two control programs, backing up the general credit restraint that is needed to bring inflation under control, will effectually prevent a resumption of the trends shown in earlier years toward much greater outflows of U.S. private capital.

For foreign private capital, we project an inflow next year of \$2 billion, compared with nearly a \$5 billion rate in the second half of last year and about \$4 billion in the full year 1968. These figures do not include Euro-bond issues to the extent the proceeds are used for direct investment or otherwise held abroad, nor do they include the flow of liquid funds to the United States through commercial banks abroad.

Before explaining these figures, I should mention our final major assumption, that long-term interest rates in Germany will not decline further next year, since the

German Federal Bank will not inject into the German banking system the liquidity that would be required to over-balance the prospective forces of demand and supply in German Financial markets. On the other hand, we are not projecting any such rapid tightening of the German financial system as occurred in 1965 and 1966. German public authority bond yields are now moderately above 6 per cent, while U.S. Government long-term bond yields are somewhat below 6 per cent. We should bear in mind, however, that general levels of interest rates for business borrowers here are higher relative to U.S. Government bond yields than is the case for corresponding levels in Europe relative to German public authority bond yields. To some extent, there have been rate pressures encouraging U.S. businesses to obtain credit from European businesses and banks; such pressures may continue, but we assume they will not become stronger in 1969.

The projected shrinkage in foreign capital inflows is explained mainly by factors other than interest rates. First, over half of last year's $4 billion inflow was to acquire U.S. stocks and to make direct investments here, and it seems reasonable, or at least prudent, to suppose that there may be a pause this year after such a tremendous surge of equity buying. Second, nearly $1-1/2 billion of last year's inflow was in such miscellaneous accounts as commercial credit, advance payments for civilian and military aircraft, bank loans to U.S. companies, and security issues abroad to the extent that proceeds were brought back to the United States by the issuers. The inflow in these miscellaneous accounts should be much smaller in 1969, partly because aircraft deliveries are catching up, but mainly because last year's borrowings abroad built up a large mass of target leeway under the Commerce Department controls, which companies will not want to expand much further and may, on balance, be using up.

Our projections for 1969 add up to a balance of $3 billion to be covered by liquid liabilities to commercial banks abroad and by official reserve transactions. Last year the corresponding figure was about $2 billion and that was more than covered by $3-1/2 billion of liquid funds from U.S. bank branches and other commercial banks abroad, leaving a surplus on the official settlements basis. This year we have already seen a net inflow through bank branches and foreign banks of about $2 billion in January. We believe that further growth of this borrowing this year will be severely limited by high cost of fresh supplies of foreign funds to the Euro-dollar market, in the absence of new waves of distrust in other currencies and in the presence of central bank policies that will limit portfolio shifts by their commercial banks out of domestic currency assets. Nevertheless, it does seem possible that our 1969 deficit on the official settlements basis may be quite small. One possible pattern might be an inflow of $2-1/2 billion of funds through banks and $1/2 billion of official reserve transactions.

With this picture, pressures on our gold reserves should be moderate--and tolerable. The state of the U.S. balance of payments should not itself prevent progress toward creation of SDR's and deliberate consideration of other changes in the international monetary system. But the footing on which we will stand looks precarious in a longer view, because this year our net exports get the benefit of a favorable cyclical conjuncture here and abroad; because capital controls to which many people are unsympathetic are still in force; and above all because interest rate relationships are more favorable now for the U.S. balance of payments than they may become later.

Mr. Hayes said he thought the staff presentation was excellent. While he had found little that he disagreed with, he did have one technical question relating to the behavior of CD's after February. In his judgment, given current Regulation Q ceilings a three-month bill rate in the projected range of 5.70 to 5.90 per cent might be associated with a tendency for the volume of CD's outstanding to stabilize; a somewhat higher bill rate--perhaps 6 per cent or slightly above--was more likely to be consistent with CD run-offs of the dimensions anticipated by the staff. Perhaps the Manager had some views on the matter.

Mr. Holmes said he thought a three-month bill rate consistently above 6 per cent might well be needed to produce the projected attrition of CD's. If the rate were around 6 per cent for some period of time banks probably would not have great difficulty in finding customers for CD's, particularly since many customers were willing to sacrifice a few basis points in yield in the interest of maintaining good banking relationships.

Mr. Brill noted that after February the projected CD run-off was relatively small--averaging around $250 million per month. Of course, he would not want to be dogmatic about the particular rate relationships which would produce that result. The projected bill rate range should be regarded as an approximation that might well require some adjustment.

Mr. Partee added that the bill rate figures under discussion were on a discount basis, whereas CD rates were quoted on an investment yield basis. Since a three-month bill rate in the neighborhood of 6 per cent would be adjusted upward by roughly 20 basis points when converted to an investment yield basis, it was clear that the range in the staff projection was actually a range around the current 6 per cent ceiling rate for 90- to 179-day CD's.

Mr. Hickman remarked that the Committee could experiment to determine the particular bill rate levels that were likely to be associated with bank credit growth at about a 5-1/2 per cent annual rate. He was somewhat puzzled, however, by the relationship between the longer-run projections given in the presentation today--which called for moderate growth in bank credit and a three-month bill rate below 6 per cent--and the projections for February given in the blue book.[1] The latter called for a bill rate in the range of 6.0 to 6.30 per cent and a decline in the bank credit proxy, including Euro-dollars, at an annual rate in the range of 0 to 3 per cent. He wondered whether the differences between the projections for February and for the longer run were related, at least in part, to the fact that February included a period of even keel.

Mr. Brill replied that the February projections did reflect the fact that even keel constraints would be in effect. The estimated rate of bank credit expansion he had cited as likely to be consistent with the GNP projections applied to the period beginning in March, and was based on the assumption that the February projection would be realized. After February, when a slowing of CD attrition was expected to be associated with a somewhat lower level of bill rates, growth in bank credit was expected to resume at an annual rate averaging about 5-1/2 per cent, although not necessarily at that specific rate from month to month.

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

Mr. Mitchell observed that he was a little surprised to find that the staff was recommending major reliance on Regulation Q ceilings and a little disturbed at the implied delicacy of the operation required to obtain the bank credit growth rate projected. He agreed that Regulation Q ceilings could be a useful tool for controlling the rate of CD attrition. He woundered whether, in the staff's estimation, it would be possible to introduce additional flexibility in that instrument by restructuring the ceiling rates applicable to different maturities.

Mr. Brill replied that the effect of changes in Regulation Q ceilings would depend on prevailing bank attitudes and expectations. For example, if the Board were to raise ceiling rates on CD's of longer maturity at the present time, banks might well construe the action as a first step in the direction of an easier monetary policy. And if banks concluded that interest rates were going to ease, they might not take advantage of the higher rate ceilings to expand their CD outstandings because that would mean a commitment to pay prevailing rates for 6 or 9 months. In short, the potential reaction of banks to an increase in Regulation Q ceilings would be affected by their attitudes about their liquidity positions and their outlook for interest rates.

In response to a further question by Mr. Mitchell, Mr. Brill indicated that the basic policy strategy proposed by the staff would be to exert continuing pressure on the banking system through open market operations and, if necessary to maintain the pressure, to supplement those operations by use of whatever other policy tools seemed appropriate. In the latter connection, if market psychology appeared to be changing in a manner that did not seem to be in accord with the basic economic situation, consideration might be given to the possibility of absorbing reserves in the spring by an increase in required reserves and perhaps also to the possibility of an advance in the discount rate.

Mr. Mitchell observed that a key point in the staff's prescription still seemed to him to be the curtailment of bank credit expansion by fostering a continuing run-off in the volume of CD's at large banks.

Mr. Brill remarked that although the initial impact of the proposed restraint would tend to fall on the money market banks most dependent on the availability of CD funds, he would expect that the restraint would soon permeate the entire banking system. Indeed, there already were some indications of such a development.

Mr. Maisel noted that the bank credit proxy had declined at an 8 per cent annual rate in the six weeks since mid-December. The staff's projection was for a smaller average rate of decline in February and an increase at a 5-1/2 per cent annual rate in succeeding months. It was not clear to him how bank credit could shift from experiencing a fairly rapid decline to a period of moderate expansion under a policy which maintained steadily firm pressure on the banking system.

Mr. Brill observed that the policy strategy recommended by the staff was based on the expectation of a substantial diminution in financial market pressures once the Treasury began its seasonal debt repayments in March. If the switch in the Treasury's position were allowed to be translated into a sizable decline in short-term interest rates, banks would be likely to move aggressively to replace the CD's they had lost and a bulge in bank credit growth could result. The staff's prescription was to resist much of the downward pressures on interest rates but to permit enough to diminish the CD run-off and thereby allow for the growth in bank credit that would be needed to accommodate the requirements of the economy.

Mr. Partee noted that one element in the staff's projection was liquidation by banks of their holdings of U.S. Government securities at a $12 billion annual rate in the first half of 1969 and at a $4 billion annual rate in the second half. Continuing pressure would have to be maintained on banks to force them into such liquidation.

Mr. Brimmer commented that the staff's GNP projection implied that the corporate sector would absorb an increased share of available resources in 1969 as a result of an expansion in expenditures on plant and equipment. The projected rise in those expenditures would account for nearly one-sixth of the increase in GNP in 1969, compared with one-tenth in 1968. That re-allocation of resources would be partly at the expense of the Federal sector and partly at the expense of the housing sector. Despite anticipated pressure on the banking system, the projection assumed that banks would help finance a volume of business fixed investment that would be growing nearly 30 per cent faster than in 1968. He wondered if there would be any way to change the incidence of monetary restraint if reliance were placed entirely on the general policy instruments Mr. Brill had mentioned.

Mr. Brill replied that in the staff projection most of the expansion in plant and equipment expenditures occurred in the first quarter. Some further rise in real fixed investment was projected in the second quarter, but thereafter the projection suggested that--while the current dollar value of plant and equipment spending would rise slightly--spending in real terms would decline. The projection implied that before the end of the year corporations would be limited both by a squeeze on profits and by monetary restraint in their ability to finance rising inventories and increased real investment in plant and equipment. Mr. Brill added that the figures on business capital expenditures incorporated in the projection were consistent with the year-over-year rise in such expenditures reflected by the latest confidential survey of the Department of Commerce.

Mr. Mitchell observed that with interest rates relatively high in the United States there might now seem to be less need for the voluntary foreign credit restraint program and the Commerce Department controls on direct investment. That conclusion would seem valid particularly if foreign monetary authorities were going to keep their domestic interest rates down by making fewer dollars available to the Euro-dollar market, which he took to be the implication of staff comments today.

Mr. Hersey agreed that actions of foreign monetary authorities to restrict the availability of funds in the Euro-dollar market might tend to keep interest rates in their countries lower than otherwise. He believed, however, that supply and demand pressures in German financial markets would tend to bring higher interest rates in that country. No doubt financial conditions projected in the United States, along with the interest equalization tax--which he regarded as still quite important--would be major factors favorable to the U.S. balance of payments. Whether the VFCR would exert much extra effect in 1969 seemed doubtful, but in view of the uncertainties that remained he thought the programs were still necessary.

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

Few new business data have come to light since the last FOMC meeting. The underlying situation undoubtedly remains one of excessive strength, with consequent inflationary pressures; prices continue to move up strongly. On the other hand, business sentiment is perhaps a bit less ebullient. There is some uncertainty about the current state of business inventories and the strength of consumer demand, but the statistics needed to assess whether any significant imbalance is developing between stocks and final sales are not yet available. Looked at in perspective, the level of new orders for machinery and equipment and other advance indicators of capital spending have been very high since mid-1968 and suggest continued strength in this area during the current quarter. On the other hand, I believe the fiscal program, coupled with our own policies, is likely to induce a slower rate of over-all economic expansion in the months ahead--although it remains quite possible that upward pressures created by the current widespread inflationary expectations may still prevent this much-to-be-desired tendency.

On the balance of payments front it is no surprise to find a sizable recorded liquidity deficit reappearing in early January data, following the remarkable capital inflow of late December. Very heavy borrowings of American banks from their foreign branches in January were provided in large part by a movement of funds out of Germany; and much of this movement in turn represents the unwinding of the speculative inflows of November. It seems reasonable to suppose that availability of Euro-dollars to meet American bank needs will be a good deal smaller in the coming months. As for the dollar's position in exchange markets, there has been general improvement in the past month, no doubt attributable in good measure to recent U.S. monetary and fiscal policy developments. Welcome though this is, it should not cause us to forget what a serious balance of payments problem we continue to face until we succeed in restoring a sizable trade surplus.

As for credit developments, we find considerable strength in the business loan statistics; but in New York at least this seems to result more from unexpectedly slow loan repayments than from a surge of new loan demands. Among the latter, large loans to finance corporate acquisitions seem to be playing a leading role among the large banks. It seems to me that if we should end up with a small decline in the credit proxy for January and February together, after adjustment for Euro-dollars, this would be a most welcome development, coming on top of the very excessive expansion of the second half of 1968. Of course I would not advocate a decline extending over a long period. But I think we should bear in mind that the growth of total credit may remain large for some time as direct lending in the credit markets is substituted for lending through the banking system. For this reason it would appear necessary to maintain a very moderate average rate of bank credit expansion for a fairly extended period of time if monetary policy is to have the desired effect on total credit flows and total aggregate demand in the economy.

Even keel considerations certainly preclude any major policy change in the next couple of weeks. But I believe purely economic factors also point to the wisdom of a "no change" policy at this time. Our objective should be to bring steady but not extreme pressure to bear on the banking system in order to induce a more restrictive attitude toward lending and investing. Despite some remarks in the press and reports by some banks and security dealers to the contrary, I think many banks are moving toward the adoption of more restrictive policies. And while there has been a fair amount of skepticism about the System's firmness of purpose in combatting inflation, I believe that money market participants have lost a good deal of that skepticism in the past week. The credit proxy data also suggest that we are beginning to get results.

Although the monetary and credit flow variables are clearly our principal policy target, even keel requirements will call for careful scrutiny of money market conditions over the next few weeks. I would think of bank borrowing in the $500 to $800 million range, or perhaps $600 to $900 million in view of the recent high figures to which the market has become somewhat accustomed. Net borrowed reserves, to which

I would give less emphasis, might range from around $400 to $600 million, but subject to temporary deviations outside these figures. The Federal funds rate might be around 6-1/4 to 6-1/2 per cent, and the bill rate might center in a 6.10 to 6.30 per cent range.

As far as the directive is concerned, the staff draft looks fine to me. Since we start out with a projected decline in the credit proxy for February, including Euro-dollars, I would accept some modest increase--say 2 to 3 per cent--before implementing the proviso on the side of mildly greater restraint. Similarly, if the proxy appears to be declining more than 4 or 5 per cent I would then favor some modest relaxation of operations, provided that market expectations are not questioning the System's resolve to maintain an over-all policy of restraint. Psychology will be an important factor in determining the economy's response to anti-inflationary restraint, and open market operations will have to be conducted flexibly with this consideration in view.

Looking beyond the next few weeks, I can see a possibility that further System policy actions will be called for. For one thing, whereas banks have not had undue difficulty adjusting so far, a drying up of the supply of Euro-dollars could put increased pressure on the money market banks where the CD run-offs have been heaviest. Up to a point this increased pressure might be welcome. But if the pressure were to become excessive, particularly with respect to the consequences for the foreign exchange markets, there might be a need to review the Regulation Q ceilings. The question of applying reserve requirements to Euro-dollar borrowings by U.S. banks involves a number of complex considerations and the answer should not be rushed as part of a short-run strategy.

There is also a possibility that an additional visible and overt tightening move may later be needed if doubts about System policy resolve should grow. A discount rate rise might become appropriate, especially if the smaller banks continue to borrow as heavily as in the past weeks. Another possible move might be a reserve requirement increase. But these are not issues that must be dealt with at present.

Mr. Francis remarked that seven weeks ago the Committee had adopted a policy designed to exercise a restrictive influence on the economic system. For seven weeks, it had been the System's intention to reduce inflationary pressures. To accomplish that required getting total spending growth down significantly from the 9.5 per cent growth rate of the past four quarters. However, the evidence was still not clear that the System had been exercising a restrictive influence in the past seven weeks. Since the week ending December 18, total member bank reserves had increased $1 billion; the monetary base had increased $600 million; Federal Reserve credit had grown $900 million; and the money supply had grown $1 billion. Interest rates, after continuing their December rise for a week after December 17, had changed little.

Mr. Francis observed that member bank borrowings had averaged $840 million since the Committee's December meeting, compared with $550 million in the period from November 6 to December 18. That increase might be a sign of increased tightness in the credit markets but it was not a sign of Federal Reserve restriction. In view of the increased margin of market rates over discount rates since November, the demand for bank loans, and the disintermediation caused by impingement of Regulation Q, it was to be wondered that borrowings had not risen more. The fact that they had not would seem to be due to the liberal supplying of reserves by open market operations.

Mr. Francis said he hoped the Committee would not feel that it had been exercising a restrictive influence since December 17 by virtue of the fact that total bank credit had ceased to grow. As the members knew, that development was due to the fact that the present relationship between Regulation Q rate ceilings and market interest rates prevented the commercial banks from acquiring or even holding time deposits. That put the banks in a tight position, but it did not restrict the credit markets in general. It forced the flow of funds into channels different from those they would have otherwise followed. That might or might not be a good thing, but it did not exercise a restraint on total credit and total spending. When Regulation Q caused disintermediation--or reintermediation when its effects were withdrawn as market rates declined relative to ceilings--total bank credit became a distorted and misleading indicator.

Not only was the moderation of growth of bank credit a misleading indicator of restraint, Mr. Francis continued, but the associated decline of time deposits released reserves to provide for further credit creation, growth of total credit in the economy, and growth of the narrow measure of the money supply. An insidious effect of the disintermediation caused by Regulation Q might be to put commercial banks under such pressure that the System would be impelled to expand Federal Reserve credit, total bank reserves, and the monetary base at continuing and even accelerating inflationary rates.

Mr. Francis remarked that Committee members might think monetary policy was tight because interest rates were high. However, the increase in rates had occurred mainly in the period from September to December 17. Thus, the rise had come prior to the time when the System's policy moved toward tightness. He urged the Committee to give some evidence that it was exercising restraint by limiting growth of bank reserves, the monetary base, and the narrow measure of money supply--or, if the members preferred, a measure of bank credit exclusive of commercial bank time deposits--to about 3 per cent per year.

For about four years, Mr. Francis said, the Committee had been led into unintended inflationary monetary expansion while following interest rate, net reserves, and bank credit objectives and the even keel constraint. He suggested that, if the Committee meant business now, it should try some other guides. Not only could the old guides lead to further inflation as long as demands for credit continued to rise, but when and if contrary trends set in they could lead to an undue contraction of total spending.

Mr. Francis observed that he was not proposing to have the Manager give the market a signal of a change of policy either tomorrow or any other particular day. He was proposing simply that the Desk be instructed to implement, gradually and carefully, the policy of intensifying restraint that was decided upon on December 17. He thought it would be a great mistake to postpone that step until the Committee's March meeting.

Mr. Francis reported that the directors of the Federal Reserve Bank of St. Louis thought the discount rate was at least 1/2 of 1 percentage point too low. At their meeting a week from Thursday (February 13) they were likely to vote for submitting a rate increase. At the present time the discount rate was about 3/4 of 1 percentage point below its average relationship with other money market rates, and since early December the volume of Federal Reserve credit extended through the discount window had been rising.

Raising reserve requirements as opposed to selling securities had not proved in the past to be an effective way to restrict the growth in aggregate member bank reserves, Mr. Francis commented. When the Manager used money market conditions as a guide to action, the effects of the reserve requirement change were offset; in addition, the System usually sought to facilitate the transition to higher requirements by supplying some additional funds. In January 1968, the System had raised reserve requirements, absorbing $550 million of reserves, to obtain some monetary restraint without placing direct upward pressure on interest rates.

But in the first quarter of that year Federal Reserve credit, even adjusted for the reserve requirement change, rose at an excessive 15 per cent annual rate, and the three-month Treasury bill rate went up about 1/4 of 1 percentage point.

Mr. Kimbrel remarked that the Committee's intention, as he understood it, was to follow a policy of moving gradually toward moderate restraint rather than moving suddenly toward drastic restraint. Consequently, the members need not be disappointed if dramatic effects were not yet showing up. At the same time, it seemed to him that the Committee should be cautious about accepting the idea that it could necessarily count on the current posture to bring about the desired slowing down.

Mr. Kimbrel said he found it especially difficult to interpret the signals being given by the financial variables. He had been advised that even with the most skillful seasonal adjustment techniques it was hard to sort out the effects of the seasonal forces that were so strong at this time of the year. Lack of extended experience with the lagged reserve plan created interpretative problems. The massive shifts out of time deposits made the bank credit proxy and the net borrowed reserve figures far from reliable as guides for the total credit availability. On top of that, there was the heavy use of Euro-dollars.

Consequently, Mr. Kimbrel observed, he could well understand the hard time that financial writers seemed to be having in deciding whether the Federal Reserve was actually carrying through on a policy of moving toward restraint. He noted that one writer had pointed out last week that, since the money supply was continuing to grow, talk of restraint was just that--talk. Another writer who had looked at the deepening net borrowed reserve figures was convinced that the System really meant business.

Mr. Kimbrel thought the Desk had performed admirably in terms of specifications given at the Committee's previous meeting. Perhaps as a result the point was approaching at which policy would begin to bite even though so far there had been no large cutbacks in bank lending and investing. In his judgment, the decline in the credit proxy in January and the prospective decline in February did not mean that policy had already become too restrictive. Those declines had to be considered in the context of the shift out of time deposits. Total reserves apparently had continued to grow in January. The continued growth in loans suggested that the pinch was not very great.

With the behavior of the financial variables so hard to interpret, Mr. Kimbrel said, he supposed it was necessary to give even more attention than usual to the way the economy was behaving. Although the staff's presentation today suggested some hope for a moderate slowdown in the future, there was little evidence that it had occurred thus far. He found that to be characteristic of conditions in the Sixth Federal Reserve District. The District economy had ended 1968 on a strong upbeat, with the unemployment rate down to 3.5 per cent. In no major type of manufacturing had seasonally adjusted employment been lower in December than in November. A high construction contract volume for December promised a continued active construction industry. Announcements of major expansion plans were frequent. Typical were three announcements made in the last quarter of 1968 for paper mills in Mississippi, Alabama, and Louisiana to cost $250 million.

That active pace was being supported by continued growth in bank loans, Mr. Kimbrel continued. In January there was an increase at large District banks in business loans, whereas--judging by past experience--a decline should have been expected at this time of the year. But more compelling evidence that policy had not really begun to bite at District banks was that not a single banker had complained to him about tightness. That was directly contrary to what had happened in 1966. Seemingly, they were enjoying a banker's paradise--lots of loans at high rates. Moreover, their actions implied that they were counting on the Federal Reserve to see that they did not come up short.

Under those circumstances, it seemed to Mr. Kimbrel that the Committee would have to be guided more by the availability of funds than by rates if it was going to contribute to a slowdown.

It might be that careful consideration should be given to a change in reserve requirements. In his opinion a change in the discount rate would be ineffective at this time.

Treasury financing limited the Committee's freedom of action for part of the next period, Mr. Kimbrel observed. In any event, he would favor a policy of no change, assuming no change in policy would be accompanied by the money market conditions described in the blue book.[1/] That set of conditions implied a decline in the rate of increase in reserves. Under those circumstances, he favored the draft directive as written. By the time of the next meeting the Committee might be better able to observe the effect or lack of effect of gradual restraint.

Mr. Hilkert remarked that the problems faced in making a recommendation on policy today were twofold: (1) judging the impact of policy actions already taken; and (2) reading the economic signs for indications of how strong the economy was

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1/ The blue book passage referred to read as follows: "As February progresses, the basic reserve position of major money market banks can be expected to worsen, partly as the recent seasonal easing reverses and possibly also because of increased demands for day-to-day funds which might stem from the Treasury refunding. The Federal funds and dealer loan rates may, therefore, tend to rise somewhat from recent levels, for any given level of total member bank borrowings. Moreover, continued CD run-offs may tend to impel somewhat greater borrowing demands from the Federal Reserve. If borrowings are in a \$600-\$850 million range in February, the funds rate might be most frequently around 6-3/8 - 6-5/8 per cent. The 3-month bill rate, under these conditions, may be expected to be in a 6 - 6.30 per cent range."

likely to be some months ahead. In judging the impact of actions already taken, he had the impression that attitudes on the part of bankers had not been consistently what policy had intended. It was desirable to foster the psychology that the System intended to exert steady pressure so as to bring inflation under control. During at least part of the past three weeks, he had had some question whether that objective was being accomplished. Nevertheless, he was impressed by the sharp downward changes in bank credit and the money supply during January. Those were firm statistics suggesting considerable impact. In addition, projections for February suggested more of the same.

Mr. Hilkert said that reading the signs for indications of how strong the economy would be some months from now was particularly important because monetary policy choices now would, in part, determine results then. Most of the firm statistics indicated continuing strength. Among them were production, employment, and business spending for plant and equipment. In addition, the behavior of industrial commodity prices made it clear that inflation continued to be the primary economic problem. Until inflation was brought under better control, no satisfactory solution to the balance of payments problem could be found.

Economic data for the Third District were not so timely as the national figures, Mr. Hilkert continued, but the information that was available also indicated over-all strength. In December, industrial production maintained its upward movement, and unemployment remained low in all District areas. The Reserve Bank's most recent business outlook survey, conducted several weeks ago, showed growing short-term optimism and a continuing bullish outlook for the coming six months.

Information suggesting slower growth was harder to come by and more difficult to interpret, Mr. Hilkert observed. For example, the cutbacks in auto output and resulting layoffs last month, and the December decline in retail sales, might be only temporary trouble spots or they might be harbingers of more widespread softening of demand.

As he added up those several observations of the economic signs and the effects of policy, Mr. Hilkert concluded that a policy of watchful waiting was the most appropriate. The basic posture should be one of restraint, but of alertness to new developments. That policy, of course, was also consistent with even keel considerations. However, he was concerned with the possibility that restraint might be overdone. Thus, if necessary to avoid pressing growth in bank credit and the money supply below the ranges projected in the blue book, he would want to give the Desk discretion to ease money market conditions to the extent possible within even keel.

Mr. Hickman said that the much-publicized cutback in auto production and the need to adjust inventories in other industries suggested that the slowdown in economic activity was becoming more widespread. Durable goods orders declined in November and December, and steel output was expected to decline by about 3 per cent in February, after four months of increase. Thus, advances in industrial production should moderate in the near future along with the growth of employment and income.

Mr. Hickman noted that expectations of some slowing of economic activity were widely shared by the business economists from major corporations who had met at the Cleveland Federal Reserve Bank on January 24. The group's median forecast of the index of industrial production for 1969 showed successive quarterly gains of one, zero, one, and two points, following gains of 1-1/2 points and 2 points, respectively, in the third and fourth quarters of 1968. The median forecast for the production index for 1969 as a whole was 169, which would represent a 2-1/2 per cent rise above the average for 1968, compared with about 4 per cent for 1968 over 1967. The group anticipated median quarterly gains in GNP this year of $12 billion, $11 billion, $14 billion, and $16 billion, which were modest by 1968 standards, but somewhat larger than had been expected at their last meeting in October. The group's median forecast for the year 1969 was $919 billion, which would represent a 6-3/4 per cent gain from 1968, closely matching the current "consensus" forecast. The group's forecast compared with a gain of 6.9 per cent presented in the staff's projection this morning and 7.1 per cent in the CEA forecast. Apparently, economists had revised their notions about the timing of the impact of fiscal changes on economic activity. Different assumptions about prolonging the income surtax had little visible effect on individual GNP forecasts for 1969.

Mr. Hickman observed that the business economists had voiced serious concern about continued inflation, to which no one saw an early end. Many doubted that the recent shift in monetary policy had had a significant effect on inflationary psychology. In fact, considerable skepticism was expressed about the strength of the System's resolution to check price inflation through monetary policy, suggesting that it might take a fairly lengthy period of time to change expectations.

Mr. Hickman felt that policy since the last meeting had been somewhat firmer than he thought desirable as an intermediate-term objective, but perhaps about right considering the general sentiment that the System was not serious in its resolution to check inflation. While the System had managed to avoid a credit crunch, CD attrition had been more extensive than he would prefer for the next several months. The credit proxy, including

Euro-dollars, actually declined in January and would probably decline again in February, if present conditions in the money market were maintained. Moreover, CD attrition had forced an increasing number of banks heavily into the Euro-dollar market and was creating undesirable pressures in foreign money markets. Severe monetary restraint might be needed to close the "credibility gap" but should not be continued indefinitely.

In the current environment, Mr. Hickman said, he would prefer to maintain the bill rate in a range of 5.90 to 6.15 per cent, which would temper somewhat the CD runoff and encourage a modest and even growth in bank credit. Such a policy would also be consistent with even keel considerations, which would prevail throughout most of the period. To the extent that supplementary reserves would have to be provided to accommodate the current Treasury financing, they should be withdrawn as soon as possible after the financing was completed. His position was slightly less restrictive than the staff's draft directive, although the differences were minor, particularly in a period when "even keel" would be the dominant consideration. Accordingly, he was prepared to vote in favor of the draft directive.

Mr. Sherrill said he favored the staff's draft directive as written. He had found the projections presented by the staff this morning to be quite helpful and thought the targets were correctly formulated. In particular, he felt that the objective of growth in bank credit over an extended period at an annual rate of about 5-1/2 per cent was a proper one, and in his judgment the bank credit contraction in January and February would result in an appropriate starting point for growth at such a rate.

As Mr. Brill had noted, Mr. Sherrill continued, there were likely to be downward pressures on short-term interest rates after mid-March, when the Treasury would be repaying debt. It would be desirable to prevent substantial declines in rates, which could be misinterpreted as reflecting a backing-off in the degree of monetary restraint. But it might be quite difficult to prevent interest rates from falling too far while maintaining bank credit growth at about a 5-1/2 per cent annual rate. While open market operations probably would be the principal tool of policy, the System should be prepared to take supplementary action, if necessary, on reserve requirements or discount rates. For the time being, however, he would prefer to hold such other policy tools in reserve while watching the course of developments.

Mr. Sherrill agreed that it was distressing to find that the recent policy intentions of the Federal Reserve had not been clear to outside observers and were being misinterpreted by many commentators. He thought, however, that the System should not be dissuaded from its present course by such reactions. Certainly, it was only a matter of time before observers would reach a correct understanding of System policy intentions from the statistics that would be coming out. The Federal Reserve was likely at that point to be faced with the opposite kind of criticism, and it would be important then for the System to hold as steadily to its policy course as it was doing now.

Mr. Brimmer said he also was prepared to accept the staff's draft of the directive. However, he was troubled by the way monetary policy was operating. In particular, he was disturbed by the fact that a small number of very large banks had been able to offset a good part of the effects of monetary restraint by drawing in Euro-dollars. According to a preliminary analysis by a member of the Board's staff, the eleven banks accounting for the bulk of U.S. bank Euro-dollar liabilities had been able to offset about one-half of their CD run-offs between December 11 and January 22 by Euro-dollar inflows. Further staff work on the subject was in process. Although Mr. Bodner was confident that the availability of Euro-dollars would be reduced in coming months, he (Mr. Brimmer) was not convinced that the large U.S. banks would find it extremely difficult to continue to acquire substantial additional amounts of such funds.

Moreover, Mr. Brimmer continued, he was convinced that the recent large Euro-dollar inflows were one source of the uncertainty in the market as to whether monetary policy was sufficiently restrictive. Many of the comments in the press about the stance of policy reflected interviews with officials of large New York City banks, and--because of their access to Euro-dollars--it was easy to see why such banks did not feel that they were under much pressure. He had encountered a similar attitude among Chicago bankers when he visited with them during the third week of January.

Mr. Brimmer noted that the large banks in question accounted for a substantial part of total bank credit. Those banks were unlikely to reduce the rate at which they were making loan commitments so long as they thought they could continue to count on the availability of Euro-dollars. It was necessary, however, to persuade them to cut down on their loan commitments. He was concerned about the risk that the System might find itself applying an unduly great degree of over-all restraint--in an attempt to compensate for the successful efforts of the large banks in effect to opt out of the pressure on their reserve positions by drawing in Euro-dollars.

Accordingly, Mr. Brimmer said, he thought the Board should consider the desirability of some action in the matter. He agreed with Mr. Hayes that there should not be hasty action to apply reserve requirements to Euro-dollar liabilities, but that possibility should be studied. He also thought the Board should consider an increase in reserve requirements on domestic deposits in about three or four weeks. He would hope that any such increase would be made in a way that would shift part of the burden of restraint from small to large banks.

Mr. Brimmer then referred to the question Mr. Mitchell had raised as to whether it was necessary to continue the voluntary foreign credit restraint program. He personally was convinced that the program should be continued; if it were not, he thought the prospective deficit in the U.S. balance of payments would be larger than Mr. Hersey had indicated. As the members knew, he (Mr. Brimmer) was currently holding regional meetings to develop information on how the program had been operating. In his judgment it would be desirable to make any necessary modifications of the program but to keep it in place.

Mr. Maisel said the draft directive was acceptable to him. He agreed that the staff's presentation today had been highly valuable. As he understood it, the goals for coming months suggested by the staff involved growth in real GNP at an annual rate of about 2 per cent, in dollar GNP at a rate in the range of 5 to 6 per cent, and in bank credit also at a 5 to 6 per cent rate. In his judgment such goals were logical. He also thought it was appropriate to cast the System's goals in terms of GNP with bank credit as an intermediate target variable--rather than, as was sometimes suggested, in terms of correcting press misinterpretations of the System's policy intentions or influencing that unmeasurable variable "inflationary psychology," except as such variables were affected by actual developments with respect to capacity use, profits, bank credit, and so forth. He also was opposed to employing, as intermediate goals, measures of price changes or statistics on the balance of payments, except as they could be influenced by actual changes in demand and capacity utilization rates.

In his judgment, Mr. Maisel continued, the System should stay with its goal of bank credit growth at about a 5 to 6 per cent rate--perhaps varying the target a little depending on market developments--simply because that represented about the limit of what monetary policy could reasonably be expected to do. He would hope that the System would not add to inflationary pressures by the creation of excessive bank credit. In a period such as the present, perhaps a little more could be accomplished by maintaining bank credit growth at a rate slightly below normal.

Beyond that, Mr. Maisel observed, it would be necessary to rely on fiscal policy. The aspect of the projection that worried him most was the sharp diminution in fiscal restraint expected after mid-year, even if the surcharge were retained. Clearly, it would be preferable for the System to stress the dangers of relaxing fiscal restraint rather than intensifying monetary restraint.

One problem for the immediate future, Mr. Maisel remarked, was the risk of an overreaction in bank credit. There had been a tendency during the past several years for the System to over-shoot its targets, particularly around times of policy change. Thus, bank credit growth had tended to fall below staff projections in periods of firming and to come out above the projections in periods of easing. In view of that history, he thought that more than the usual degree of fine-tuning with respect to the money market and reserve variables would be required in the coming period to keep bank credit within the projected range. The Desk should interpret the proviso clause more narrowly, particularly if bank credit growth were negative, than it had at times in the past, including the most recent period.

Such a course should be appropriate for the next month or two, Mr. Maisel observed. Problems of maldistribution of funds within the banking system might then arise; if so, it might be necessary to consider the use of other instruments of policy.

Mr. Daane remarked that the Treasury financing called for an even keel policy in the period immediately ahead. He accepted the staff's analysis and draft directive, and he was prepared to see bank credit decline further in February, as projected in the blue book. He thought that for purposes of the proviso clause the Manager should focus on the bank credit proxy series which included Euro-dollar borrowings.

Mr. Daane added that on the basis of the evidence available and the analyses made to date, he did not believe that monetary policy had been or was likely to be vitiated by Euro-dollar developments. Unless further evidence and analysis led to a contrary conclusion, he would not be willing to select that area for special policy action.

Mr. Mitchell thought that while the System should not overreact to current criticism of monetary policy it should not take such criticism lightly. Mr. Maisel had suggested that the Committee should focus on quantitative targets rather than on market psychology; but the rate at which banks were making loan commitments at present was influenced by the prevailing psychology. If banks were making commitments today on the basis of a misreading of monetary policy intentions, their efforts to meet those commitments later could produce a credit crunch. Thus, market attitudes were of importance to the System, and they seemed to him to be particularly important at the present juncture.

Nevertheless, Mr. Mitchell said, the latest monetary statistics offered evidence that the System was achieving its goals, and he thought market participants would soon be persuaded of that fact. In that connection, he had been rather surprised by Mr. Francis' observations this morning with respect to the money supply. According to the blue book, money supply growth had fallen to a 4-1/2 per cent annual rate on average in January and contraction at a rate of 1 to 4 per cent was projected for February. The January figure was still an estimate, but probably a good one; and the February projection seemed to be based on a reasonable analysis. He did not see how one could ask for a more pronounced change.

Mr. Mitchell observed that the Committee members appeared resolved to fight inflation. He thought the System would need all the resolution it could muster in coming months--particularly after the Treasury began repaying debt--when it was likely to be subjected to criticism of a nature entirely different from that it was now experiencing.

In concluding, Mr. Mitchell said the staff's draft of the directive was acceptable to him. He commented that he would have favored no change in policy at this time even in the absence of a Treasury financing.

Mr. Heflin reported that the latest information on the Fifth District suggested a moderation in the pace of business expansion, although it was difficult at this stage to make very precise allowances for seasonal factors. Respondents in the Reserve Bank's latest survey reported cutbacks in the rate of both automobile and general retail sales, with further softening in residential construction. Textile markets continued to show little buoyancy, and nondurables manufacturers in general reported declines in new orders and backlogs. Nonetheless, industrial construction apparently continued to move ahead at a good clip. Business loans at District weekly reporting banks so far this year showed only normal seasonal strength.

At the national level, Mr. Heflin observed, more substantive evidence of some moderation in the business advance was beginning to appear, although the recent sharp run-up in industrial prices should remind the Committee that its job was far from finished. Moreover, business investment spending continued to move ahead at a disturbing rate in the face of a substantial moderation in the growth of final sales. That, it seemed to him, suggested a potential imbalance in the economy that could make problems for the System later this year.

Mr. Heflin said he was not entirely sure just what the System could do to slow down business spending before serious excesses developed. But it was reasonably clear to him that high interest rates were not likely, in the current climate, to produce that result. The business community apparently was still not convinced of the System's determination to contain the boom and to dissolve the inflationary expectations that underlay their spending plans. For that reason, he thought it would be a serious mistake to relax the present degree of restraint to any extent at all. Rather, he thought it was important that all the policy indicators should reflect the System's determination to combat inflation. To him it was especially important at this juncture to keep a tight rein on bank credit. While he would not like to see a zero or negative rate of growth of credit over any extended period, he believed that the January figures could well produce a desirable sobering effect on market expectations. He would hope that rate could be kept near zero over the next four weeks although, by way of emphasizing the System's determination, he would be prepared to accept some further decline for that period. In any event, he thought that in the present circumstances it would be a mistake to allow bank credit to show any substantial growth over the next month.

The February refunding would no doubt complicate the Desk's task over most of the period until the Committee's next meeting, Mr. Heflin remarked. Markets had preserved a surprisingly good tone lately despite the large run-off of CD's. Nevertheless, he believed that the market situation was still potentially unstable and he was not confident that the market would take the refunding in stride. Even so, he would be inclined in the current circumstances to interpret even keel as allowing some upward drift of market rates if that was necessary to keep bank credit from growing much faster than the rate projected in the blue book.

Mr. Clay commented that the basic economic problem that had to be solved remained essentially the same as earlier--namely, an overextended economy with strong price inflationary pressures and expectations. Evidences of change in the current and prospective patterns of economic activity were mixed. While there was some indication of a slower rate of over-all growth, the attainment of a balanced performance at a sustainable pace was still something to be hoped for. The demand for qualified manpower outran the available supply, and upward pressure on costs and prices persisted with continuing inflation as a general public expectation.

Monetary policy had to maintain its recent posture of restraint, Mr. Clay said. The indicated decrease in bank credit probably was more restrictive than was intended by present policy, but it should be acceptable as a short-run development following the large credit growth of recent months. Moreover, the deposit contraction thus far was quite concentrated in the largest banks and did not permeate the banking system generally.

Consideration also had to be given to the risk involved in giving any misleading signal to the public concerning the drive against price inflation, Mr. Clay continued. While the monetary policy of restraint should be implemented in an orderly fashion, it was important that the public should become convinced of the resoluteness of purpose of the Federal Reserve System to restrain price inflation.

Mr. Clay observed that Treasury financing would be a constraint on monetary policy for a substantial part of the period until the next meeting. He thought that, quite apart from that factor, monetary policy should continue essentially unchanged. The draft policy directive appeared to be satisfactory.

Mr. Helmer commented that the current outlook was for some easing of pressures on economic resources. Thus far, however, economic activity continued to maintain a strong momentum in the Seventh District. With the exception of passenger cars, no important District industry had reported significant adjustments in production plans. And in the automobile industry, production in the first quarter normally was cut back substantially as inventories of new models were brought to desired levels. It appeared now that first-quarter production was likely to be at least 90 per cent of the fourth-quarter total. There appeared to have been no weakening in the vigorous demand for trucks and trailers.

Mr. Helmer noted that orders for machine tools, railroad equipment and various other capital goods and components had strengthened late in 1968. Except for isolated cases, producers of capital goods in the District currently were concerned more by rising material costs and severe labor shortages than by the trend of new orders.

Steel orders improved further in January, Mr. Helmer said. In the last full week of January output of raw steel in the Chicago and Detroit areas had been within 91 per cent of the 1968 peak rate, compared to 88 per cent for the nation. Except for autos, he had been unable to uncover any concern that inventories might be excessively large.

Price increases were posted in late January for a sizable list of commodities, Mr. Helmer continued, including textiles, chemicals, sugar, asbestos, and numerous products containing nonferrous metals. Unemployment compensation claims were at an extremely low level in the District, as in the nation, in January. Increases in wage rates still appeared to be accelerating.

Demand for funds to finance construction projects--both construction loans and permanent financing--was intense, Mr. Helmer observed. Interest and commission charges had reached new highs, and special deals with an equity interest for lenders were increasingly common. Seven per cent usury limits applicable to loans to noncorporate borrowers in Illinois and Michigan might be revised. One proposal under active consideration in Illinois would raise the limit to 9 per cent, and would clarify troublesome ambiguities with regard to various classes of borrowers and lenders. Institutional lenders other than savings and loan associations had virtually abandoned the market for mortgages on single-family homes. While housing and home construction financing might be handicapped by existing institutional obstacles to the free flow of credit, that should not be an important consideration in the Committee's current policy decision. It might be helpful, however, for the System to call attention again to the tendency for legal limits on interest rates to interfere with optimum flows of credit to various sectors.

The dock strike was having an adverse impact on exports of District agricultural products, Mr. Helmer said. With exportable supplies available from other sources, delays in shipment from the United States were likely to cause loss, not just deferment, of exports from this country.

Mr. Helmer noted that credit demands at District banks continued strong. Although business loans had declined rather sharply in the final week of January, net repayments for the month as a whole had been smaller than usual despite the rapid rise in those loans during November and December. Borrowing at District banks by metals manufacturing firms had increased much more than seasonally and relatively heavy use of bank credit was reported for most other industrial categories also. Consumer and mortgage loans had continued to increase fairly steadily, but lending to finance companies and securities dealers had been cut back sharply and a substantial volume of Government securities had been liquidated as CD's had run off. The two largest banks had now more than recouped their year-end outflow of Euro-dollars.

Mr. Helmer observed that the cumulative decline in negotiable CD's at the large Chicago banks now exceeded $400 million--a loss of about 20 per cent from the December peak. But attrition since the first of the year was somewhat less than had been feared and, because of their ability to draw on the Euro-dollar market and the liquidity built up last fall, it had not caused severe problems as yet. Nevertheless, their borrowings at the discount window had been more frequent and further tightening in either Euro-dollar or domestic securities markets would be likely to result in increased use of the window. A growing share of recent borrowing, however, had originated from smaller reserve city banks, some of which had also lost relatively large amounts of CD funds.

Mr. Galusha observed that since the recent experience of Ninth District banks and savings and loan associations seemed to have been roughly the same as that of others across the country, there was no need for him to go into any detail on the subject.

He would note only that, generally speaking, inflows of funds to District banks and thrift institutions had decreased, and that the outstanding CD liabilities of the largest banks had declined by $75 million--or by around 60 per cent of the dollar value of maturing CD's--in the four weeks ending January 22. Unless Committee policy was changed, institutional flows would likely not increase again soon; and that being so, he was not confident that the sharp economic advance of the fourth quarter would be sustained very far into the future.

Mr. Galusha remarked that he favored no change in Committee policy at this time and would have taken the same position even if the Treasury had not just opened its subscription books. The policy of the past few weeks, perhaps with slight modifications in months to come, would bring relatively small increases in nominal GNP--and not just over the first half of the year, but straight through to the end of 1969.

Mr. Galusha said he accepted the various monetary targets specified under "Prospective Developments" in the blue book, and favored the staff draft directive as written. He would caution the Manager, however, against an excessive run-off of CD's--or, what might come to the same thing, against letting market rates go above their specified upper limits. In a very brief period, the Committee had effected a considerable change in the rate of growth of bank credit, possibly even too considerable a change; and however much inflation there had been, the Committee had constantly to be mindful of the risk of being too restrictive. The present was definitely a time, he believed, for the two-way proviso clause in the directive. However much heat a posture of moderation might engender--and he had no doubts at all that the voices of the System's critics would become quite shrill before the current episode was in the past--the long-run interests of the country would be better served by persistent and consistent policies applied flexibly in modest increments rather than by overreactions.

By the same token, Mr. Galusha said, he endorsed Mr. Brill's suggestion that the System should lean against the wind to keep the bill rate from falling significantly below 6 per cent if interest rates came under downward pressure later. He thought Mr. Hayes had stated admirably the conditions on which he (Mr. Galusha) would want to have the proviso clause implemented.

Mr. Swan remarked that in the Twelfth District, as elsewhere, it was difficult to find specific evidence of any substantial change in the economic situation. He would note that data into early January on initial claims for unemployment compensation in the District suggested that the unemployment rate might have risen from its relatively low level in December. While the damage from recent rains and floods had been heavy, particularly in the Los Angeles area, early indications suggested that there had been little crop damage and probably little interruption to economic activity except construction activity.

There appeared to have been no great change in the last three weeks in the positions of major banks in the District, Mr. Swan said. Those banks were still able to borrow heavily under repurchase agreements with corporations.

Turning to policy, Mr. Swan noted that even keel constraints would apply in the coming period. However, he would have favored no change in policy even if the Treasury were not engaged in a refunding. In his judgment, the changes in bank credit and the money supply projected for February, taken in conjunction with the estimated changes in January, were not necessarily inconsistent with the objective of moderate rates of growth over a longer run. That was particularly true in light of the rapid growth rates of the latter part of 1968. He would accept the directive as drafted by the staff. He thought the two-way proviso clause shown in the draft was appropriate, and he agreed with Mr. Hayes' comments regarding its implementation.

Mr. Coldwell reported that the economy of the Eleventh District remained at a high level. Employment was still strong and unemployment was extremely low. The unemployment rate in

Dallas, for example, was 1.2 per cent, which was practically equivalent to no unemployment.

Recent developments at District banks reflected seasonal influences and a reduction in time and savings deposits, Mr. Coldwell said. CD run-offs had been nominal thus far and February maturities were small. Business loan demand was very strong, and bankers with whom he had talked indicated that high interest rates were having little restraining effect on borrowers. Although data on the liquidity positions of banks revealed that the margin of available funds was narrowing, the banks still appeared to be able to take care of their customers.

During the past ten days, Mr. Coldwell continued, there was evidence that, for the first time since 1966, large national customers were beginning to draw on lines of credit at interior banks. District bankers were only now beginning to believe that there might be some restraint over the horizon, but they reported that their customers remained in a "business as usual" mood.

Mr. Coldwell remarked that he had little to add to what had already been said regarding national economic conditions. It seemed to him that the economy was still operating at a high level. Growth had slowed, but there was no evidence visible of an economic downturn and no convincing evidence that the slowing was marked. Cost-price inflation and expectations of further inflation were deeply rooted, and he did not think that much of a dent in the prevailing inflationary psychology had been made thus far. National financial conditions reflected massive seasonal flows, with CD run-offs offsetting injections of Euro-dollars and with declines in needs for dealer financing nearly offsetting net liquidity drains. Credit restraint was just beginning to be evident at the margin; few banks had changed lending policies as yet.

As to policy, Mr. Coldwell commented that while the Treasury refunding argued for maintaining steady conditions some marginal shift was still possible. Since high interest rates were exerting little restraint, and since credit availability was only now beginning to be limited, one could make a case for a slight intensification of monetary restraint. In that connection it should be recognized that maintenance of a given level of net borrowed reserves meant the replenishment of reserves used by the banking system.

However, Mr. Coldwell continued, in view of the beginnings of mild restraint through the export of national borrowers to interior banks, and in view of the Treasury refunding, he would support the staff's draft directive calling for maintaining prevailing firm conditions. He would favor maintaining such conditions even if that required deeper net borrowed reserves, larger member bank borrowings, and higher interest rates, since the alternative would mean once again backing down too early from a policy of restraint.

Mr. Morris noted that he had dissented from the directive adopted at the previous meeting because it would have permitted an absolute contraction in bank credit. He had felt then--and felt still--that while the trends in the economy warranted a moderately restrictive policy they did not warrant a severely restrictive policy. In his judgment current policy, if adhered to for too long a period, would prove to be a policy of too much too late.

Since the meeting of the Committee three weeks ago, Mr. Morris continued, there had in fact been a contraction in bank credit--even though large banks had been able to tap the Euro-dollar market on a massive scale--and a further contraction was projected for the month ahead. He had the impression from conversations with officials of a large Boston bank with access to the Euro-dollar market that they did not feel they were escaping the impact of monetary restraint. Assuming that availability of additional Euro-dollars would be limited in the months ahead, it seemed to him that the current posture of policy could not be adhered to for long without generating disorderly markets. Given the current trends in the economy, which seemed to be pointing clearly toward further deceleration of economic growth, he would prefer to have the Committee establish a more moderately restrictive policy of a kind that could be maintained for a longer period of time.

Mr. Morris noted that the staff projections for 1969 suggested that growth in the economy would slow substantially from the excessive pace of the last half of 1968. The projections also suggested that by the fourth quarter of 1969 the unemployment rate would have risen to 4.2 per cent and the increase in the GNP deflator would have subsided to an annual rate of less than 3 per cent. Those projections seemed reasonable to him, both in the sense that they were consistent with current economic data and in the sense that they represented appropriate goals for policy. He noted, however, that no account had been taken of the possible deflationary implications of a settlement in Vietnam.

Mr. Morris went on to say that the staff projections implied a shift in the behavior of bank credit from contraction in the first two months of the year to growth at a 5-1/2 per cent rate thereafter. In his judgment, a more nearly steady pattern of bank credit growth would be appropriate to the economic conditions of 1969. It could be argued that the logic of economic events had made a financial crunch almost inevitable in 1966, but in his judgment no such case could be made for 1969.

Since his convictions had placed him in the role of the devil's advocate, Mr. Morris remarked, he would be bold enough to suggest that the Committee might be overreacting to the misjudgments of last summer and fall. As a consequence, the Committee might be giving too much weight to discussions of monetary policy such as were appearing in some parts of the press and too little weight to the staff's economic projections. The article by Edwin Dale in yesterday's New York Times, captioned "Laughing at the Fed," had prompted him to make an informal survey of his own of some of the people who were active in the Boston financial market. He found no one who was laughing about the current stance of monetary policy. Even officials of the large banks which had been tapping the Euro-dollar market had no doubts about the effectiveness of current policy in the short term. Some evidence that that feeling might be spreading southward from Boston was provided by the signs of technical deterioration that had developed during the past ten days in the stock market--the first signs of technical weakness since last August.

The main concern of the people in Boston with whom he had talked, Mr. Morris said, was that a short period of excessive monetary restraint would be followed by a period of excessive monetary ease, on the pattern of 1966-68. If that should happen, long-run inflationary psychology might become more deeply rooted than it was today.

In arguing for a policy of moderate rather than severe restraint, Mr. Morris observed, he was arguing for a policy that could be maintained for more than a few months. To implement such a policy, he would suggest that the proviso clause of the directive be revised to read as follows: "provided, however, that operations shall be modified to the extent necessary to avoid a contraction in bank credit including Euro-dollar." The difference between the staff's draft of the directive and the modification he had suggested might seem minor, but he thought it could represent the difference between a policy which could be sustained for a longer period and one which would have to be reversed in March or April.

Mr. Robertson presented the following statement:

> We are, of course, in a period of "even keel", and that calls for a basically unchanged monetary policy for its duration. This gives us the chance to use this time to weigh very carefully the effectiveness of the policy actions we have already taken. Obviously some financial flows are shifting, but we have to be sure to look through superficial movements to focus on those with real potential for cooling off the thrust of the economy.
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> Given the strength of the inflationary pressures we are battling, we may well find we have more work to do, and if so, we ought to be prepared to act again as quickly as we can. In that case, we might be well advised not to wait for our next regularly scheduled meeting on March 4, but instead to call a special meeting just as soon as we can regard "even keel" as being over.
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> If we find we need to tug still harder on the monetary reins, we should lead off with an increase in reserve requirements, using open market operations and

a discount rate increase as follow-up actions if and as needed rather than as initial steps. Final judgment as to what order of policy actions might be best, of course, can only be reached when the day arrives; but as of now it seems to me that we are most likely to need a widely visible signal of curtailed availability of reserves--and reserve requirement action fills this bill better than any of our other instruments. Whether it should apply to demand deposits or time deposits--and when and in what fashion--or even to funds brought back from foreign branches (if, by then, we are in a position to do so) are questions to be decided then.

In my view, it would make most sense to key any discount rate increase to the development of overborrowing at the Reserve Bank discount windows, if and as that occurs.

One action I am reasonably sure I would not favor is any increase in Regulation Q ceilings. I think they are very much a part of such monetary restraint as we have been able to introduce up to now, and raising them could only relax the bite on the banks and add to the impression that the System lacks the determination to carry through on a really restrictive credit policy. And that, I submit, would be a damaging blow to the posture of the Federal Reserve as a responsible central bank.

Against the background of these views, I would be prepared to vote for the draft directive as submitted by the staff. I would not favor adoption of the proviso clause suggested by Mr. Morris.

Chairman Martin remarked that there appeared to be relatively little disagreement among the members with respect to policy today. He concurred in the view that the Treasury financing precluded a policy change and that no change would be appropriate at this time even apart from the financing. However, the current period of even keel did offer the System an opportunity to reassess its general policy stance.

The Chairman then observed that in his judgment a proviso clause of the type Mr. Morris had suggested probably would not prove workable. Since the other members had spoken in favor of the staff's draft of the directive, he suggested that the Committee vote on that draft. If that directive was not acceptable to Mr. Morris he could, of course, cast a dissenting vote.

Mr. Morris said he thought he would have to dissent from such a directive since he would find it difficult to associate himself at this juncture with a policy that was consistent with a continuing decline in bank credit.

Mr. Mitchell remarked that in his opinion the difference between Mr. Morris' position and that of other members was smaller than might appear at first glance. Mr. Morris wanted to avoid bank credit contraction, whereas other members were prepared to accept a decline in February at the rate projected by the staff. However, the mid-point of the range projected in the proxy series including Euro-dollars was minus 1-1/2 per cent, which was not very far from zero. Mr. Morris also had indicated that he would not want to have bank credit continue to decline for an extended period. He (Mr. Mitchell) shared that view, although he would not object to some decline in February since he thought there was a pool of liquidity that should be absorbed. Indeed, he agreed with almost everything Mr. Morris had said except with respect to the desirable timing of a resumption of growth in bank credit.

Mr. Morris remarked that while one could easily overemphasize small arithmetical differences, he thought there was a significant difference between a directive that could be viewed as consistent with a decline in bank credit at an annual rate of up to say, 5 per cent, and one under which the Manager would be subject to criticism if a decline of that magnitude occurred.

Chairman Martin said he did not think the Committee would be contemplating a decline in bank credit at a 5 per cent rate in February if it adopted the directive submitted by the staff. In his judgment, the members actually were not far apart.

Mr. Maisel concurred in the views expressed by Messrs. Morris and Mitchell. He hoped the Manager would not construe the directive as permitting any major deviation in bank credit from the projection. It was important for the Manager to keep looking three or four weeks ahead for indications of the path on which bank credit was moving. The rather sharp drop that had occurred in the past two weeks probably implied that the daily average for February would be lower than that for January. Since those monthly relationships would reflect past actions, they were less important as this juncture than were the changes in credit expansion which occurred in future weeks. The Manager should make certain that no acceleration occurred in the rate of decline since to achieve the goals outlined in the staff report, expansion not contraction was necessary.

Mr. Morris said that in light of the comments just made he would find it possible to cast an affirmative vote on the directive.

Mr. Hickman observed that he agreed in general with the views of Mr. Morris and he concurred in the opinion that it would be important for the Manager to watch bank credit developments closely in coming weeks.

Mr. Hayes remarked that he would like to add a few brief observations. First, he was fully in accord with the majority view today and was prepared to vote favorably on the directive. At the same time, he had sympathy for an even-handed, persistent approach, and he thought that many of the members felt the same way. Certainly, he would want to guard against adopting an unduly restrictive policy that would have to be reversed quickly. However, he did not think the policy course under discussion today was of that type.

Secondly, Mr. Hayes said, he agreed with Mr. Daane that Euro-dollar acquisitions by U.S. banks had not vitiated monetary policy and were not likely to do so. As far as banks in New York were concerned, he did not have the impression that their positions were considerably easier, apart from seasonal factors, than those of other banks in the country. There had been a short-run seasonal swing in reserves in the favor of New York banks during the last few weeks. At the same time, they had experienced a higher rate of CD attrition than the banking system as a whole, and that might well continue. From his conversations with New York bankers he had the impression that they felt no more comfortable than the Boston bankers to whom Mr. Morris had referred. Insofar as there was talk of monetary ease in banking circles, it seemed to be no more extensive in New York than elsewhere.

Mr. Francis said he would like to amplify his earlier observations on the money supply in view of Mr. Mitchell's comment during the go-around. He certainly preferred the January growth rate of 4-1/2 per cent to the average rate of close to 8 per cent in the three preceding months, but the money supply in January nevertheless was still on the trend line of the past 24 months. He hoped the lower rate of money growth projected by the staff for 1969 would be realized. His basic concern, however, was that the growth rates of the monetary aggregates, which he believed had an influence on total demand, were "fall-outs" of policy rather than the object of policy under the present method of System policy formulation.

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

> The information reviewed at this meeting suggests that expansion in real economic activity has been moderating, but that upward pressures on prices and costs are persisting. Prospects are for some further slowing in economic expansion in the period ahead. Market interest rates recently have fluctuated near the highs reached around the turn of the year. Bank credit contracted slightly in January on average, as the outstanding volume of large-denomination CD's continued to decline sharply, inflows of other time and savings deposits slowed, and growth in the money supply moderated. The U.S. balance of payments on the liquidity basis appears to have reverted to deficit in early 1969, but large inflows of Euro-dollars have had the effect of keeping the official settlements balance in surplus. 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.
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> To implement this policy, while taking account of the current Treasury refunding, 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 appears to be deviating significantly from current projections.

Mr. Farrell, Director of the Division of Federal Reserve Bank Operations, Board of Governors, entered the meeting at this point.

Chairman Martin suggested that the Committee consider the memoranda relating to the Treasury's cash and debt ceiling problems to which Mr. Holmes had referred earlier. He had discussed the matter at some length with the Treasury people, and he understood the latter were canvassing the views of other officials of the Administration and also members of the appropriate Congressional Committees. The possibility of seeking legislation to increase the statutory debt ceiling was being actively explored. The proposals for assisting the Treasury in connection with their problems should be viewed as measures for possible use in case of an emergency need; it was to be hoped that the Treasury would not have to rely on them. At the moment some people thought that the Treasury's problems were not as acute as had appeared earlier, but not everyone was agreed that that was the case.

In response to the Chairman's request for comment, Mr. Holmes said he had little to add to his memorandum of January 30. As noted in that memorandum, the Treasury had been reviewing alternative means of meeting their combined cash and debt ceiling problems, including three that would require Federal Reserve assistance. Of the three, one would have involved immediate credit by the Reserve Banks for Government deposits. However, it was the opinion of Federal Reserve counsel that the Reserve Banks were not authorized to grant immediate credit to the Treasury while denying such credit to other depositors, and the Treasury had agreed to withdraw that suggestion since alternative means of System assistance were available. The second means would involve a speed-up of payments to the Treasury of interest on outstanding Federal Reserve notes not secured by gold certificates, and there appeared to be no particular problems with such a procedure. While the benefits to the Treasury would be relatively small, they might conceivably help to ease the Treasury through the crucial period.

The third possible means of Federal Reserve assistance, Mr. Holmes continued, would involve warehousing by the System of foreign exchange assets held by the Exchange Stabilization Fund. At the moment, the Fund held slightly over $800 million of foreign currencies, including about $730 million of sterling. Thus, the warehousing approach, if implemented, undoubtedly would provide an adequate backstop for the Treasury.

In his judgment, Mr. Holmes said, the Treasury's position now looked better than it had earlier. Treasury officials were continuing to explore avenues other than those involving Federal Reserve assistance. It would be unthinkable for the Federal Government to violate the debt ceiling, and the prospect of the Treasury's failing to pay its bills was not a pleasant one. Accordingly, if as a last resort the Treasury asked the System to warehouse foreign currencies temporarily, it might be desirable for the System to cooperate.

The Chairman then noted that a memorandum from the Committee's General Counsel, on the legal aspects of the matter, had been distributed on January 31. He asked Mr. Hackley to comment.

Mr. Hackley said it seemed fairly obvious that the best solution to the Treasury's problem would be an increase in the statutory debt ceiling. Since, as Mr. Holmes stated in his memorandum, "the Treasury's problem was not related in any way to current developments in the international situation," the proposed warehousing of foreign currencies might be criticized not only on the grounds that it involved a direct extension of credit to the Treasury but also on the grounds that it was a device to enable the Treasury to get around the statutory debt ceiling. However, if it appeared that a timely increase in the debt ceiling was not likely, and if System warehousing of foreign exchange holdings of the Stabilization Fund appeared to be the only practicable means by which the Treasury could avoid either breaching the debt ceiling or failing to meet its contractual obligations, he thought such warehousing operations would be legally defensible.

The Chairman then noted that a third memorandum on the subject, from the Secretariat, had been distributed on February 3. He asked Mr. Holland to comment.

Mr. Holland observed that the bulk of the Secretariat's memorandum consisted of a hypothetical entry for the Committee's record of policy actions that might be used if and when the Committee formally approved the warehousing proposal. The staff thought the hypothetical entry might be helpful to the Committee in articulating a possible basis for Committee agreement on the matter. That basis would consist of the following elements. First, the Committee would agree to approve the warehousing proposal formally--perhaps by telegraphic vote of the members--only after receipt of advice from the Treasury that there was no practicable alternative if the Treasury were to meet its cash needs while staying within the debt ceiling. Secondly, the agreement to warehouse foreign currencies would be temporary in two senses--in that warehousing would be undertaken only "in the months immediately ahead," and in that any foreign currencies warehoused by the System would be reacquired by the Exchange Stabilization Fund "within a reasonably short period." The staff had not proposed any explicit time limits, but the Committee might want to specify particular dates.

In addition to offering the hypothetical policy record entry, Mr. Holland said, the Secretariat's memorandum raised the question of whether immediate public disclosure of the warehousing operations should be made if they were undertaken. The memorandum noted various possible forms of disclosure, either by the System alone or in a joint announcement with the Treasury.

Mr. Heflin remarked that since the System could be subject to hostile criticism in the matter it was important in his view to proceed extremely carefully. In that connection, he noted that

Mr. Hackley had said in his memorandum that his opinion that there would be no legal objection to adopting the warehousing proposal was "premised, of course, upon the assumption that legislation increasing the debt ceiling cannot reasonably be expected in time to resolve the Treasury's problem." He (Mr. Heflin) thought the Treasury should be urged to seek an increase in the debt ceiling before asking the System to warehouse foreign currencies. In his judgment warehousing operations would be hard to defend if an increase in the debt ceiling had not been sought. There would be a better justification for such operations if legislation had been requested but for some reason was not enacted in time.

Chairman Martin commented that Mr. Heflin's point was well taken.

Mr. Maisel said he had no objection to the general principle of the proposed warehousing operations. He objected strongly, however, to the basis for such operations suggested by the staff in the hypothetical policy record entry. In particular, he was disturbed by the language of the draft proposing agreement by the Committee that "under existing circumstances it would be appropriate in the months immediately ahead for the Federal Reserve to warehouse Stabilization Fund holdings of foreign currencies temporarily if necessary for the purpose of enabling the Treasury to meet its cash needs while staying within the debt ceiling." That statement implied to him that the System's objective would be simply to enable the Treasury to avoid the legal debt ceiling.

In his judgment, Mr. Maisel continued, a much better basis for the proposed warehousing operations was available--namely, the need to coordinate the foreign currency operations of the System and the Treasury. That was an area which the Committee had considered and acted upon on a number of occasions in the past. On those occasions, he had pointed out the need for a better coordination in concepts and decision-making of the System's and Treasury's operations with respect to short- and intermediate-term credit to and from central banks and governments. The present situation made clear the need for such coordination.

One means by which the Treasury might resolve its current problems, Mr. Maisel observed, would be to sell the foreign currency holdings of the Stabilization Fund in the market, but such sales clearly would have highly undesirable consequences from the point of view of the System as well as the Treasury. He thought it would be appropriate for the System to warehouse foreign currencies temporarily for the Treasury for the purpose of avoiding the need for their sale in the market.

Mr. Mitchell remarked that he shared that view. He noted that Mr. Hackley's memorandum had referred to the possibility that the Treasury might find itself obliged to sell large amounts of foreign currency holdings in the market in order to stay within the debt ceiling, and that such sales could result in disorderly exchange market conditions. However, in a postscript to the Secretariat's memorandum Mr. Hackley had asked that that statement be regarded as omitted, and the Secretariat's memorandum itself made no reference to market sales. He (Mr. Mitchell) favored assisting the Treasury temporarily by warehousing foreign currencies, but would prefer to do so on the grounds that Mr. Maisel had mentioned.

Mr. Daane said he thought there would be difficulties with the course Mr. Maisel had proposed. For the Committee to imply in its published policy record that the sale in the market of the Stabilization Fund's foreign exchange holdings had even been considered as a realistic possibility could have damaging effects on the attitudes of the System's central bank partners. The general approach taken in the staff's hypothetical entry seemed appropriate to him, although some editorial changes and a shortening of the text might be desirable.

Mr. Hayes indicated that he agreed with Mr. Daane. He noted that an early draft of the Secretariat's memorandum, which had been sent to Messrs. Coombs and Holmes for comment, had referred to the possible sale in the market of the Stabilization Fund's foreign currency holdings. In his judgment, such language would be unrealistic and dangerous.

In response to a request for comment, Mr. Bodner said he thought the problem with which Mr. Maisel was concerned seemed less serious when the passage the latter had quoted from the hypothetical policy record entry was read in the context of the full entry--particularly against the background of a preceding statement to the effect that "among the factors contributing to the currently low cash position of the Treasury were past operations of the Exchange Stabilization Fund in acquiring pounds sterling and German marks . . . in implementing the international financial policies of the United States." Perhaps any residual problem could be met by modifying the draft language while maintaining the present general framework.

Mr. Bodner went on to say that, as Mr. Holmes had noted earlier, the bulk of the Stabilization Fund's present foreign currency holdings consisted of sterling. Of the latter, $383 million consisted of guaranteed sterling. There were certain understandings between the Treasury and the Bank of England regarding the disposition of such holdings. The remaining $355 million of sterling represented the counterpart of short-term swap drawings by the Bank of England on the Treasury. In his judgment it would be completely counter to the purpose of the arrangement for the Treasury, having extended short-term credits to a foreign central bank, to think in terms of selling the related IOU's in the market. To do so would simply render such swaps meaningless.

More generally, Mr. Bodner said, any suggestion that under certain conditions the Treasury would consider dumping a substantial part of its sterling holdings on the market could have extremely serious effects in the market itself. In addition, as Mr. Daane had indicated, such a suggestion could have adverse effects on the attitudes of the System's central bank partners.

Mr. Maisel noted that the Committee had already authorized System warehousing of Stabilization Fund holdings of guaranteed sterling to assist the Fund if its resources were inadequate to meet the demands on them. As to the Fund's other holdings of sterling--those that were a counterpart of British swap drawings on the Treasury--the System might agree to take over those drawings temporarily if the Treasury could not afford to carry them. It seemed to him that such procedures were to be preferred over a procedure in which the System, in effect, lent money to the Treasury to enable it to get around the debt ceiling statute.

Chairman Martin remarked that extensions of credit to the British might well have originally been undertaken exclusively by the System rather than jointly by the System and the Treasury.

Mr. Brimmer said he wanted to associate himself with Mr. Heflin's view that the Treasury should be urged to seek an increase in the debt ceiling before asking the System to assist it by warehousing foreign currencies. If the Treasury then still needed assistance he would hope that the System would provide it by warehousing guaranteed sterling--in the manner already provided for under earlier arrangements--rather than by taking over other assets of the Stabilization Fund. He added that the hypothetical policy record entry said past operations of the Stabilization Fund were "among the factors" contributing to the Treasury's low cash position. But certainly the most important factor was the level of Federal expenditures, and it was with the latter in mind that Congress had enacted the debt ceiling statute. He thought it would be highly undesirable for the System to act simply on the basis of helping the Treasury avoid the debt ceiling.

Mr. Hickman said he was disturbed by the proposal to publish a statement which could be read to imply that the System had warehoused Stabilization Fund assets to enable the Treasury to avoid the debt ceiling. He would favor deletion of the passage in the hypothetical policy record entry that Mr. Maisel had quoted earlier if an entry on the matter were eventually published in the Committee's policy record.

Mr. Holmes noted that any warehousing transactions the System might undertake would be reflected in the figures shown in the System's weekly condition statement. Since the Treasury's debt ceiling problem was well known, it would not be difficult for an outside observer to make a connection between that problem and the change in the figures shown in the condition statement. In his judgment it would be better to search for language for the policy record that would make the proper connection between warehousing operations and the debt ceiling problem rather than to delete references to the debt ceiling from the entry.

Mr. Daane concurred in Mr. Holmes' observation.

Mr. Brimmer added that if the Treasury sought legislation to increase the debt ceiling the subject would clearly be in the public domain.

Mr. Daane commented that in the interest of reducing the likelihood that System warehousing operations would be needed it might be desirable to urge the Treasury to go as far as feasible in shifting securities held by the trust funds into outstanding marketable issues. He agreed with the view of counsel that it would not be appropriate for the Reserve Banks to grant immediate credit on Government deposits. However, he thought the proposal to speed up System interest payments on Federal Reserve notes should be given favorable consideration, particularly if, as the Manager had suggested was conceivable, the marginal contribution of that step might be adequate to meet the Treasury's problem.

Chairman Martin remarked that he thought there would be no disagreement with respect to the desirability of speeding up System interest payments if that would be helpful to the Treasury.

The question, of course, was whether it would be particularly helpful.

The Chairman then said he would pursue his discussions of the warehousing proposal with the Treasury on the basis of the comments today, which he understood to reflect a general sentiment in favor of assisting the Treasury in that manner if there were no practicable alternative available. To his mind the issue Mr. Heflin had raised was a key one, and in his discussions he would try to make sure that the Treasury officials fully understood the System's position on the matter. The Committee did not have to decide today on the language of the policy record entry to be published in the event such warehousing was undertaken, but he was sure that the members would want to adhere to the System's policy of full disclosure.

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

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

February 3, 1969

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on February 4, 1969

The information reviewed at this meeting suggests that expansion in real economic activity has been moderating, but that upward pressures on prices and costs are persisting. Prospects are for some further slowing in economic expansion in the period ahead. Market interest rates recently have fluctuated near the highs reached around the turn of the year. Bank credit contracted slightly in January on average, as the outstanding volume of large-denomination CD's continued to decline sharply, inflows of other time and savings deposits slowed, and growth in the money supply moderated. The U.S. balance of payments on the liquidity basis appears to have reverted to deficit in early 1969, but large inflows of Euro-dollars have had the effect of keeping the official settlements balance in surplus. 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 current Treasury refunding, 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 appears to be deviating significantly from current projections.