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, June 24, 1969, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Coldwell
Mr. Daane
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Scanlon
Mr. Sherrill
Mr. Treiber, Alternate for Mr. Hayes

Messrs. Francis, Heflin, Hickman, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Morris, Kimbrel, and Galusha, Presidents of the Federal Reserve Banks of Boston, Atlanta, and Minneapolis, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Baughman, Eastburn, Gramley, Green, Hersey, Reynolds, Solomon, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account

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

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

Messrs. Taylor and Jones, Senior Vice Presidents of the Federal Reserve Banks of Atlanta and St. Louis, respectively
Messrs. Eisenmenger and Hocter, Vice Presidents of the Federal Reserve Banks of Boston and Cleveland, respectively
Messrs. Garvy and Kareken, Economic Advisers, Federal Reserve Banks of New York and Minneapolis, respectively
Messrs. Bodner and Wallace, Assistant Vice Presidents of the Federal Reserve Banks of New York and Richmond, respectively
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on May 27, 1969, were approved.

With respect to the memorandum of discussion for the meeting held on May 27, 1969, the Secretary reported that one revision on page 3 of the preliminary draft, which was indicated in the memorandum of proposed changes, had inadvertently not been made in the revised draft distributed before this meeting. He noted that corrected copies of the affected page would be distributed following the meeting.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on May 27, 1969, was accepted.

Chairman Martin reported briefly on the Sixteenth Monetary Conference of the American Bankers Association, held in Copenhagen on June 15 to 20, which he had attended along with Governors Daane and Mitchell and Presidents Hayes, Scanlon, and Francis. Although not much of substance might have been accomplished, he said, there had been some interesting discussions to which he had sought to contribute in speaking at the closing meeting.

The Chairman noted that the Monetary Conferences had been initiated as the outgrowth of discussions when he was Assistant Secretary of the Treasury. It had been his opinion that the usefulness of the ABA's annual convention was limited by the extremely large attendance, running into the thousands, and that it would be helpful to supplement the convention with a small conference of perhaps 50 or 60 top officials of U.S. banks, at which monetary problems could be considered in greater depth. Unfortunately, the size of the Conferences had grown over the years--more than 300 people had attended one of the sessions at Copenhagen--and they were now distracted by the spotlight of publicity attendant upon them. He hoped it might be possible to restore something of the original flavor of the Conferences, although admittedly that involved problems for the ABA, and he suggested that those in the Federal Reserve might use their offices to counsel in that direction.

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 May 27 through June 18, 1969, and a supplemental report covering the period June 19 through 23, 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 Treasury's gold stock remained unchanged, as it had for a year. The Stabilization Fund's gold holdings now stood at $794 million, about unchanged since the previous meeting of the Committee.

Mr. Bodner commented that the principal feature of international financial activity during the past month had, of course, been the Euro-dollar market. The intense pressures in that market had resulted in major flows of funds that had dominated developments in both the gold and exchange markets. As the Committee was well aware, interest rates in the Euro-dollar market had been moving up steadily through the spring months, and in mid-May had reached levels over 9-1/2 per cent. Shortly after the previous meeting there had been a jump to 10-1/2 per cent, and during the course of early June there had been a further escalation as U.S. banks drew steadily increasing amounts from the market. Rates hit a peak of about 13 per cent per annum on June 10 following the prime rate increase of the preceding day. Although there had been some easing since then, rates currently were about 11 per cent for maturities of one to six months, and the available evidence indicated no slackening in the demands being made on the market by U.S. banks. Indeed, after having risen by just over $1 billion in each of the first two weeks of June, those borrowings advanced by over $1.25 billion in the week ended last Wednesday (June 18). With the mid-year window-dressing period on the continent now coming up, most market observers were looking for a renewed increase in rates before the month-end.

So far, Mr. Bodner said, the Euro-dollar market had proved remarkably resilient in the face of those unprecedented demands. Indeed, he doubted that the most optimistic observers would have thought that such a period of extraordinarily high interest rates could be experienced without any really serious dislocations in the market. One major reason seemed clearly to be that the market had been heavily supplied from this country, if the recent U.S. balance of payments figures were any guide. Nevertheless, he thought it would be dangerous to be too sanguine about the prospects for the immediate future. There would be sizable withdrawals of funds by several continental countries at the month-end, and with the flow into the market from Germany virtually at a halt until today, continued heavy pressure from U.S. banks could yet result in some serious difficulties in the market.

Any such pressures were likely to be felt not only in the Euro-dollar market itself, Mr. Bodner continued, but, of course, also in the exchange markets. Few major currencies had escaped the impact of the Euro-dollar pressures and if those should intensify, a further round of the kinds of defensive measures that had already been taken in a number of countries probably could be expected. Indeed, the Dutch had indicated at the last Basle meeting that they were actively considering measures to restrict the access of their banks to the Euro-dollar market. That was in response to a heavy drain on Dutch reserves during the past month as the Netherlands Bank was forced to spend some $100 million in supporting the guilder at the floor. As the Committee was aware, the Dutch had reactivated their swap line for a total of $82 million to date.

Mr. Bodner noted that similar pressures had been felt among the Scandinavian countries, with Sweden in particular having lost nearly $60 million in the past month and the Danes becoming increasingly concerned about their ability to maintain the present parity. The Belgian franc also had been driven to the floor, but the Belgian reserve position had not deteriorated quite so much because the Belgians had already instituted requirements for their banks to repatriate funds. Nevertheless, the National Bank of Belgium had had to make some further use of the swap line; their drawings presently stood at $130.5 million. The Belgian franc was under pressure again this morning. It was, of course, the smaller countries that had been the most vulnerable to the Euro-dollar pressures and that had been most anxious to see something done on the U.S. side to reduce those pressures.

Mr. Bodner remarked that among the major countries the picture had been somewhat, but not entirely, different. For most of the period, Germany was the major European supplier of funds to the Euro-dollar market and the heavy demands served a useful function by encouraging the reflux of speculative funds from Germany. The German Federal Bank had assisted in that reflow by maintaining relatively attractive swap rates as well as by supporting the spot rate just below par. Consequently, by June 11, the German Federal Bank had sold on a spot or swap basis about $3.5 billion of the nearly $5 billion that had come in during April and May. By then, however, short-term interest rates in Germany had begun accelerating rapidly and, with large tax payments due at the end of June, the Germans had become concerned about the level of domestic liquidity. They consequently had adjusted both their spot and forward intervention rates and those measures, along with the natural adjustments taking place in the market, had resulted in a complete halt in the outflow from German reserves. However, the outflow had resumed today.

The situation in France had of course been different, Mr. Bodner said, although there too the high Euro-dollar rates had brought additional pressure, within the limits imposed by exchange control. Bank of France losses during the period had been heavy and continuous, and from the beginning of June through last Friday had reached a total of over $400 million. The French trade situation continued to look weak and the forthcoming wage negotiations posed a further threat to the position of the franc. Meanwhile, to cover losses this month the French had had to draw further on the credit lines established last November. Moreover, at the end of May, the French had obtained $250 million from the Germans as a recycling credit. The French had repaid that credit this month, but to do so they had had to draw a substantial amount of the remaining leeway under the November arrangement. There probably was less than $150 million still available under those lines, allowing for the fact that some of the participating countries did not have funds to advance. Although the franc had strengthened following the announcement of the new French cabinet, its longer-run prospects looked no better than they had for some time.

In Italy, Mr. Bodner observed, the central bank had taken some defensive measures in March to require Italian banks to repatriate substantial funds by the end of June. Those measures had tended to protect Italian reserves over the past few months--although the lira had frequently been at or close to the floor as the bank note outflow from Italy had continued at a very high level. During the past weekend the Bank of Italy had moved again, raising the discount rate to 5 per cent from 3-1/2 per cent for those banks that had made heavy use of their rediscount privileges.

Mr. Bodner remarked that the only countries that might be said to have escaped the pressures to some extent were the United Kingdom and Switzerland. Throughout the past month, the British had continued to take in small amounts of dollars and, following the publication of good trade figures for May, they had picked up a fairly substantial amount. The absence of more obvious pressures on sterling would seem to be accounted for by the very great tightening of credit in Britain and by the fact that the sterling balances of the non-sterling area already had been run down to such a very low level. Clearly, a major risk in the U.K. situation was the political difficulty of maintaining the credit squeeze over a long period. Moreover, although the market seemed to have taken it fairly well, the inability of the government to push through the union legislation did not augur well for the future; and with sterling now coming into a seasonally more adverse period the outlook was rather bleak.

As the Committee was aware, Mr. Bodner continued, Britain would be drawing approximately $500 million from the International Monetary Fund at the end of June under the new $1 billion standby facility. On present intentions, some $200 million would be used to repay short-term credits from the Bank for International Settlements that had been made in anticipation of the drawing. In view of the small rise in British reserves so far this month, some part of the remaining $300 million probably would be needed to finance the mandatory repayments under the second sterling balances arrangement. Consequently, it now seemed likely that there would be somewhat less money left over for repayment of drawings on the System swap line than originally had been anticipated--perhaps no more than $100 million.

The one major currency which he had not yet mentioned, Mr. Bodner said, was the Swiss franc. There too, the pressures in the Euro-dollar market were exerting an influence that was disturbing the usual June pattern. Because of the high rates available on dollars, Swiss banks had been reluctant to begin repatriating funds for the month-end. At the same time the Swiss National Bank, concerned about the over-all shortage of liquidity in the Swiss market, had advised the banks that it would make short-term swaps available for the month-end only to a total of $250 million, with each bank assigned a specific quota. The bulk of those swaps had already been done and the money returned to the

Euro-dollar market. The National Bank expected the rest of the liquidity needs--thought to be on the order of $500 million--to be met through rediscounting of paper with the National Bank or spot sales of dollars to that Bank. So far, however, the Swiss franc had remained below the ceiling and some of the Swiss banks reportedly believed that they would be able to get through the end of the month simply by rediscounting paper, without having to sell dollars.

Finally, Mr. Bodner remarked, he might say a word about the gold market, which also had been affected by the high cost of dollars. After a rather long period during which the price had been very stable at $43.50--with the South Africans feeding out just enough gold to keep the price from rising and not enough to bring it down--the market had begun to break at the end of May when Euro-dollar rates jumped to levels over 10 per cent and when South Africa began making substantial transfers out of its published gold stock. Those transfers were seen in the market as indicating sizable current South African sales and that, coupled with the rising cost of holding gold, encouraged a fairly sizable liquidation of private positions which brought the price down to below $41.00. There was, in fact, no indication that those transfers did represent large current South African sales; it seemed more likely that they were simply a rebuilding of the fund that South Africa had set aside to disguise market sales. During the last couple of weeks, the market had quieted down and the price tended to center on about $41.40. This morning the price had declined to $41.20 and the indications were that it would be somewhat lower in the afternoon.

> By unanimous vote, the System open market transactions in foreign currencies during the period May 27 through June 23, 1969, were approved, ratified, and confirmed.

Mr. Bodner said he had only one recommendation for a formal action by the Committee today, relating to Belgian use of the swap line. A small drawing--in the amount of $3 million--by the National Bank of Belgium would reach the end of its first three-month term on July 16. If the drawing were renewed for another three months and remained outstanding for its full term the Belgian line would have been in continuous use for more than one year. Accordingly, under the language of paragraph 1D of the foreign currency authorization, renewal for a three-month period would require specific authorization from the Committee.

Mr. Bodner noted that the Belgians anticipated taking in dollars during the course of the summer. In a conversation yesterday they had indicated that they had every expectation of repaying, before the one-year period elapsed, the drawing in question and also two other small drawings--of $2.5 million and $4 million, maturing on July 2 and 3, respectively--for which Mr. Coombs had recommended renewal at the previous meeting of the Committee.

Therefore, he (Mr. Bodner) recommended renewal of the $3 million drawing if requested by the National Bank of Belgium. He should add, however, that at the next meeting the Committee probably would have to consider the renewal of several larger Belgian drawings that would again raise the question of maturities extending beyond the one-year limit.

Mr. Maisel said it had been his understanding that the Committee interpreted the one-year limit as applying not to individual drawings but to the swap line as a whole. Specifically, he thought the rule was that, in the absence of special authorization, outstandings should be zero at some point within any twelve-month period.

Mr. Bodner remarked that that was his understanding also. In the case under discussion, the latest date on which the National Bank of Belgium had had no drawings outstanding was just before a drawing on September 30, 1968, so that the one-year period would be exceeded if they did not repay their outstandings in full by September 30, 1969. Technically, renewal for three-month periods of the three small drawings in question would permit them to remain outstanding until October 1969, but as he had indicated the Belgians expected to liquidate those drawings before maturity. The course he recommended was one the Committee had followed in the past--for example, in connection with British drawings--of authorizing renewals of drawings on the understanding that they would actually be repaid before the one-year limit was exceeded.

In response to a question by Mr. Hickman, Mr. Bodner said that that understanding would apply to the three small drawings maturing through July 16. As he had mentioned earlier, there were other drawings by the National Bank of Belgium maturing soon that would again raise the question of the one-year limit.

> By unanimous vote, renewal for further periods of three months, if requested, of the swap drawings by the National Bank of Belgium maturing in the period July 2-16, 1969, was authorized.

Mr. Bodner then noted that a memorandum from the Special Manager1/ had been distributed to the Committee last week which outlined the current situation with respect to the warehousing arrangement between the System and the Stabilization Fund and transmitted a request from the Treasury that the Committee consider a temporary expansion of that facility. As the memorandum indicated, under the current interpretation of the $1 billion warehousing authority, only $350 million was available for financing the general operations of the Stabilization Fund and $195 million of that authority was presently in use. The members would recall that the warehousing arrangement went back to

1/ A copy of this memorandum, dated June 18, 1969, and entitled "Request for a more liberal interpretation of the $1 billion warehousing facility for the Stabilization Fund," has been placed in the Committee's files.

November 1963 when the Committee had authorized warehousing of up to $100 million of currencies in which the Treasury had outstanding indebtedness. At that time the lira was weak and there was an opportunity to acquire lire to cover Treasury securities denominated in that currency, but the Stabilization Fund did not have sufficient resources for the purpose. Subsequently, in April 1966, the authority was increased to $200 million. Then, in November 1967, as noted in Mr. Coombs' memorandum, the authority was increased to $350 million in connection with the credit package to the United Kingdom that was then being negotiated. At that time it was specifically spelled out in the Committee's discussion that the $150 million additional authority was to be used for warehousing guaranteed sterling. In 1968 the authority was increased to its present level of $1 billion in connection with the Treasury participation in the Second Group Arrangement for financing sterling balances. The memorandum of discussion clearly indicated that the additional $650 million was to be used solely for that purpose, although there was nothing in the language of the foreign currency authorization to that effect. To sum up, although the language of the authority was general, the staff believed that the clear intention of the Committee to date had been that not more than $350 million of warehousing should be made available to the Stabilization Fund for general purposes and, of that $350 million, not more than $200 million might be in currencies other than guaranteed sterling.

As things stood at the moment, Mr. Bodner continued, it was likely that the $155 million available for further warehousing under that interpretation would not prove adequate in the next few months. There was every possibility that the French would be in to sell a substantial amount of gold in the near future in view of the large drawings on their swap lines they had made this month. In addition, there might be other calls on Treasury resources. The only readily available source of funds other than the System would be monetization of some of the Stabilization Fund's large gold holdings. A decision on what to do with the Stabilization Fund gold was currently under discussion at the Treasury, but the Treasury clearly preferred not to have to make and execute that decision immediately. One course under consideration, for example, was using the gold to repay the $800 million owed to the IMF. If the Treasury decided to go in that direction, however, it might well want to wait to make the move in connection with other negotiations in the Fund.

Mr. Bodner observed that the question at issue was simply whether the System believed it was both desirable and necessary to force the immediate, or early, monetization of some of the Stabilization Fund's gold holdings, or, alternatively, whether it was prepared to give the Treasury some leeway in timing the execution of that decision. The monetary effects were the same in either case--that is, purchase of the foreign exchange from the Stabilization Fund added to the money supply in exactly the same way as did monetization of the gold. In any case, it was clearly the Treasury's intention to make use of the gold holdings and, consequently, the need for additional warehousing should prove to be a temporary one. He was, therefore, suggesting simply a temporary liberalization of the understandings governing the use of the warehousing arrangement. Since the language of the authority was not restrictive no formal action by the Committee appeared to be necessary.

Mr. Coldwell asked whether adoption of the course Mr. Bodner recommended might not create problems later, if a need arose for use of the warehousing authority for the original purposes but it was found that the necessary leeway was already employed.

Mr. Bodner replied that circumstances were conceivable under which the present over-all authority to warehouse $1 billion for the Treasury might prove inadequate, as Mr. Coombs had pointed out in his memorandum. The Treasury's commitment under the second sterling balances arrangement remained in force, and it was possible that the British would make drawings on the BIS of sufficient size to require the BIS to activate its standby facilities with the U.S. Treasury and other participants in the arrangement. If that should happen at a time when the Treasury had already warehoused a substantial volume of foreign currencies with the System it might prove necessary to increase the over-all limit on amounts warehoused.

However, Mr. Bodner continued, he thought such a combination of events was highly unlikely. At the moment the British were authorized to have drawings of only $35 million under the second arrangement, and they were in the process of repaying earlier drawings. The resources of the BIS currently seemed adequate to finance any likely British drawings. The latter could become substantial only if there were a sharp reduction in sterling holdings of the overseas sterling area, and there were no indications that such an event was in the offing. Thus, the chances that the BIS would activate its standby facility with the Treasury seemed small; and even if it did so, there would still be the option of asking the Treasury to raise the necessary funds by means other than warehousing currencies with the System.

Mr. Mitchell noted that Mr. Bodner had suggested a "temporary" liberalization of the understandings on use of the warehousing authority. He asked whether that could be interpreted as meaning liberalization only for the remainder of 1969.

Mr. Bodner replied that a Treasury decision regarding Stabilization Fund gold holdings was likely to be made during the next month but the question of the date of execution remained open. As he understood it, the matter might be resolved well before the end of the year, and the year-end was likely to be the outside limit.

In reply to questions by Mr. Brimmer, Mr. Bodner said the Treasury might want to utilize a substantial part of the $650 million of the warehousing authority that originally had been earmarked for use in connection with the second sterling balances arrangement. However, he did not think they planned to use the full amount. Moreover, any use would be temporary, since the Treasury definitely was going to make some decision soon about the gold holdings of the Stabilization Fund. From the System's point of view it was immaterial whether the decision was to monetize the gold or use it to repay debt to the IMF; under either procedure the Stabilization Fund would have the resources to repay the System.

Mr. Maisel commented that the question of whether or not the Stabilization Fund's gold holdings should be monetized had been a major one in the 1930's, and was still significant today. He would be willing to support Mr. Bodner's recommendation since it called for only a temporary arrangement. However, he thought the System should not permit its resources to be used to enable the Treasury to avoid monetization at the Treasury's discretion unless there was a thorough exploration of the underlying issues. Those were not detailed in the memorandum under discussion.

Mr. Daane said he agreed with the principle Mr. Maisel had expressed but did not think it applied to the Treasury's current situation. As he understood it, the Treasury wanted to provide against the contingency that the IMF would activate its $800 million claim on U.S. gold, and was prepared to monetize the Stabilization Fund's gold holdings if the IMF did not do so.

Mr. Maisel observed that the issue seemed to him to be one of a not very good or elegant form of window dressing. The claim of the IMF on the Treasury was not new; it had been outstanding for many years.

Mr. Daane agreed that the claim was of long standing but noted that the question of whether it should be exercised had recently been raised in some quarters. Accordingly, he thought it was desirable to give the Treasury the kind of flexibility it sought.

Mr. Robertson noted that Mr. Bodner had indicated that under certain circumstances it could prove necessary to raise the present $1 billion limit for warehousing, and asked how high a limit might prove necessary.

Mr. Bodner replied that under the most extreme circumstances an increase in the limit to $1.650 billion would be required.

Those circumstances would arise if the Treasury should utilize the full $1 billion authority now existing for present purposes and then be faced with a request by the BIS for activation of the entire $650 million Treasury standby under the second balances arrangement. As he had indicated earlier, however, he did not expect any increase to be required, and he had raised the point only because some possibility existed.

Chairman Martin asked whether there would be any objection to temporarily liberalizing the understandings regarding use of the warehousing authority on the basis discussed today.

> It was agreed unanimously that the informal understandings governing use of the existing authority to warehouse up to $1 billion of foreign currencies for the Stabilization Fund should be temporarily liberalized to permit use of the full facility for the general purposes of the Stabilization Fund without limitation as to currency.

The Chairman then invited Mr. Mitchell to comment on the recent meeting in Basle that the latter had attended.

Mr. Mitchell said that the discussion covered four main topics. The first concerned the progress being made by the United States in its fight against inflation. He had reported that the System was exerting steady and continuous pressure, and that the results of its monetary policy were beginning to show up in financial markets and in a reduction in the rate of real economic growth. The second topic had to do with the British position. Governor O'Brien of the Bank of England appeared to be quite apprehensive about the consequences of another possible wave of speculation in marks. He had not expressed much confidence in the government's program and was frankly pessimistic about the possibility of Britain's going further into debt. British officials at the Monetary Conference in Copenhagen had taken the position that the results of recent government measures were in train and should lead to an improvement in Britain's position in late 1969 or in 1970. Perhaps Governor O'Brien's attitude at Basle reflected fatigue from fighting the battle for so long.

Mr. Mitchell remarked that the third topic discussed at Basle--and the one that got the most attention--was Germany's decision not to revalue the mark. There was not much Dr. Blessing could say except that Germany was trying to neutralize the effects of speculative flows into the mark through recycling and other measures. But his comments did not forestall questions as to why Germany had not revalued or taken other actions.

The fourth topic, Mr. Mitchell continued, related to U.S. participation in the Euro-dollar market. That subject was discussed at some length, but he should note that the Basle meeting was held the day before the meeting of experts and, of course, before Euro-dollar borrowings of U.S. banks had reached their present level. The views expressed generally followed the pattern Mr. Bodner had described today. Representatives from Germany, Italy, and Switzerland did not express any concern about developments in the Euro-dollar market. In fact, President Stopper of the Swiss National Bank had said that the Swiss authorities were grateful for the resulting upward pressure on their domestic market rates. He (Mr. Mitchell) was not sure how President Zijlstra of the Netherlands Bank felt. The British had larger headaches than the Euro-dollar market and had not expressed concern. The French had made no specific comment. On the other hand, the Belgians and the Swedes were quite vocal on the subject. On the whole, the discussion had been friendly but inconclusive.

Mr. Mitchell said he might conclude by quoting two statements that Dr. Zijlstra had made in the course of a speech at the luncheon on June 9. The first was as follows: "I fully recognize that there are limits on the ability of central banks to resist the depreciation in the value of money. But they must use their powers as fully as possible. This means that in the operating model of central banks the money supply must be taken as an independent variable; otherwise there would be little reason to have central banks at all." That statement was in the tradition of Dutch monetary analysis, but it struck him as interesting considering the environment. The second quotation was as follows: "In this situation, it is not surprising that the dollar is affected by the troubles of the system--seeing that it is the principal reserve currency of the system and that the U.S. Treasury is still the supplier of last resort of monetary gold. While we may expect that SDR's will be approved without long delay, they cannot be expected to resolve the problem fully so long as gold is kept as a valued reserve medium."

Chairman Martin then asked Mr. Solomon to report on the three European meetings he had recently attended--the meetings of Working Party 3 and the Group of Ten Deputies, and the meeting of experts at the BIS on the Euro-dollar situation.

Mr. Solomon remarked that he would resist the temptation to begin his report by quarreling with the second of Dr. Zijlstra's statements that Mr. Mitchell had quoted. At the Working Party 3 meeting, the British situation had been given a very careful review as part of the process leading up to the approval of use of the General Arrangements to Borrow in connection with the standby agreement under which the British had now drawn \$500 million from the IMF. The upshot of the discussion was that there was still some skepticism about the ability of the British to achieve their balance of payments objectives, which had been scaled down from earlier. They now expected to achieve a surplus of 300 million pounds during the current fiscal year. Their fiscal policy was pretty well set--which sounded like a familiar statement--but they were preparing to use monetary policy more fully. They had already begun to do so, and had set a limit on the expansion of monetary aggregates. They were employing a new concept of "domestic credit expansion," defined as the increase in bank deposits plus or minus the balance of payments deficit or surplus. The rationale for that concept was that excess domestic monetary expansion could be disguised when part of it was absorbed by a payments deficit. A staff memorandum on the subject was available to any Committee member who wanted to pursue the subject further.

The Working Party looked rather closely at the U.S. situation, Mr. Solomon said. The state of the U.S. balance of payments was an important consideration to be taken into account for activation of SDR's, a subject also discussed at this meeting. As one might expect, there was some sentiment that U.S. policy might usefully employ a little less gradualism and be more harsh in slowing down the economy, but that view was far from unanimous. There was puzzlement about the way in which U.S. monetary policy worked and particularly about its impact on the Euro-dollar market. The U.S. representatives were asked specifically why the United States had not acted as many European countries had, to place direct restrictions on banks' domestic lending.

The Euro-dollar market itself was discussed at both the WP-3 meeting and the experts' meeting in Basle, Mr. Solomon continued. He had little to add to Mr. Mitchell's comments. Considerable concern was expressed by some participants, and two types of problems were noted. Some countries were worried about the impact of high Euro-dollar rates on their own interest rates and on their reserves. But the Germans welcomed the rise in Euro-dollar rates because it gave them leeway to raise their domestic interest rates without attracting foreign money. The second concern was about the effect on the viability and stability of the Euro-dollar market itself of the current very high levels of interest rates. There was a danger, some felt, of failures of some borrowers and irrational acts of withdrawal on the part of some depositors.

Finally, Mr. Solomon said, WP-3 and then the Group of Ten Deputies discussed the creation of SDR's. He could sum up the discussion in WP-3 by saying that some concern was expressed that early activation of SDR's might hinder balance of payments adjustment, in that it would provide financing to some deficit countries who might then take less vigorous action on their own; but there also was a realization that failure to create new reserves could frustrate the adjustment process. Under Secretary Volcker had made an excellent statement on the subject, in which he said that if other countries followed their past behavior, the major consequence of not creating reserves would be to force balance of payments deficits back on the United States. In the end, no one felt that SDR's should not be created in the near future.

The question for the Group of Ten Deputies, Mr. Solomon remarked, was not whether SDR's should be created, but how much--but that group did not attempt at this meeting to reach a specific conclusion on the question. The range of discussion was from $2 billion a year up to $4 billion or more, and his guess was that the outcome would fall within that range. Whether the first decision to allocate SDR's would be for a full five years also was in question. The main concern in that connection was about the U.S. balance of payments deficit and whether it would constitute a large source of reserves for the rest of the world.

Mr. Solomon said that an increase in IMF quotas next year also came up for brief discussion. The question was whether to have a general increase, selective country increases, or both. He thought there was agreement that that issue would not be allowed to interfere with the activation of SDR's. The French representative said he understood that some members wished to give priority to SDR activation and that he had no objection to such a course; but that the French themselves would like to have a special quota increase.

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 May 27 through June 18, 1969, and a supplemental report covering June 19 through 23, 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:

> Most interest rates reached new historical high levels over the four weeks since the Committee last met, a period dominated by a growing feeling of pressure within the banking and financial community. The increase in the prime rate to 8-1/2 per cent on June 9 highlighted the interest rate developments and touched off a rapid upsurge in short-term interest rates which is amply described in the written reports to the Committee. In yesterday's regular Treasury bill auction average rates of 6.52 and 6.87 per cent were established respectively for 3- and 6-month bills, up 40 and 65 basis points from the levels established in the auction just preceding the last meeting of the Committee.
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> Despite all the frenzy, which reached a peak just prior to the June 16 tax date, the money and credit markets were able to turn in a creditable performance. The ability of the major banks to pull in funds from the Euro-dollar market--while causing its own set of problems--alleviated the need to dispose of Government and municipal securities in the domestic markets. In the absence of selling pressure, yields on long-term Government securities actually declined over the period, despite competition from record high yields on corporate securities. In

the corporate market, a large volume of new issues generally moved well at rising interest rates. The tax-exempt market, in contrast, continued to show a heavy tone even though a number of new issues were postponed, either because of market conditions or because of interest rate ceilings.

Generally speaking, the markets appear to have learned to live--albeit not too comfortably--with the unsettled conditions that have prevailed recently. Carrying costs are, of course, extremely high. While dealer firms have had to take substantial losses on inventory and continue to be apprehensive about the future, there does not appear to be evidence of any extreme financial problems in the dealer community. In fact, the passage of the tax date without disaster appears to have led to some relaxation of market tensions, and the weak performance of the stock market has begun to convince some market observers that there may be some hope for the bond market after all.

While there appears to be a growing conviction that anti-inflationary policies will take hold, it would appear likely that the money and credit markets will continue to be vulnerable and sensitive to day-by-day developments in the domestic economy and on the international scene. The mid-year interest-crediting and Euro-dollar window-dressing period is likely to provide the next test for the markets, and there will be constant pressure from Government agency financing and the return of the Treasury to the market in July to contend with. The municipal market still appears to be the greatest problem area. Banks have recently been forced to take on more short-term tax-exempt notes than they want, and this supply, together with the pent-up demand from States and localities, is still overhanging the market. Thus, I would agree with the blue book's[1/] conclusion that substantial upward pressures on both

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

long- and short-term interest rates are likely to continue, but that a shift away from inflationary expectations could become a major factor in long-term markets.

Open market operations over the period since the Committee last met had to be flexibly adapted to take account of the pressures in the central money market exerted by bank apprehensions about tax-date problems and to handle a large volume of foreign sales of Treasury bills. Banks generally tended to be very cautious in managing their reserve positions, and with the major money market banks running heavy basic reserve deficits there was a tendency for money market conditions to be very taut before the weekend and to ease thereafter. Accordingly, open market operations were used to inject reserves early in the statement week, while matched-sale purchase agreements again proved invaluable as an instrument for absorbing temporary reserve excesses late in the statement week. Over the period foreign official accounts were heavy net sellers of Treasury bills, with the total reaching $1.7 billion--mainly reflecting the diversion of funds to the Euro-dollar market by Germany. As the written reports indicate, the System bought approximately $1.2 billion of Treasury bills net from foreign accounts, including some purchases that were designed solely to keep bills out of a very unreceptive market. In general, it proved possible to offset any unwanted reserve impact from these purchases, although a rather schizophrenic set of operations was required on several occasions.

As far as monetary aggregates are concerned, both the bank credit proxy and the money supply appear to be turning in a weaker performance in June than anticipated at the last meeting. The credit proxy--after adjustment for the large increase in Euro-dollars--is currently projected at a 2 to 4 per cent rate of decline for the month, and a further decline is tentatively projected for July. The statistics are not easy to interpret, however, and there has not been time to analyze completely the results of the new statistical information collected on the growth of nondeposit liabilities at the banks. It appears, however, that banks were able to offset at least part of the decline in deposits by the use of various new instruments, so that a further rough adjustment of the proxy would bring it to about a zero growth rate. And there is continuing evidence of still further expansion of credit outside of the commercial banking system.

As far as the period ahead is concerned, I have nothing to add to the discussion of money market conditions contained in the blue book, although I would stress that there are major uncertainties, and not all of them statistical, that lie ahead. Open market operations will have to be adapted flexibly to meet shifts in sentiment that may arise as the markets and the banking system continue to live with, and adapt to, cumulative conditions of monetary restraint.

Mr. Mitchell asked if the dimensions of mid-year demands for Euro-dollars by European banks for window-dressing purposes could be estimated.

Mr. Holmes replied that prevailing uncertainties made it difficult to predict the volume of funds that European banks might choose to repatriate. It was his impression, however, that high interest rates were tending to keep more funds invested in the Euro-dollar market than had been anticipated.

Mr. Mitchell inquired whether there was any specific information available concerning outflows of funds from the United States to the Euro-dollar market.

Mr. Bodner indicated that the Federal Reserve Bank of New York had conducted a survey among its contacts in New York banks at the request of the Board staff. While no systematic evidence was uncovered, the general impression was that funds were being drawn out of the country into the Euro-dollar market. Foreigners were reported to be making net sales of equity securities and considerable interest was being shown by individuals and small corporations concerning methods of transferring funds to the Euro-dollar market. In general, banks appeared to be observing the foreign credit restraint guidelines and were not undertaking to transfer funds for customers, but it appeared that funds were flowing out of the country nevertheless. The balance of payments statistics also suggested that substantial movements of funds were occurring, but none of the market specialists contacted in New York could report that significant transfers of funds were being reflected on their books.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 27 through June 23, 1969, were approved, ratified, and confirmed.

The Chairman then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts have been placed in the files of the Committee.

Mr. Partee made the following introductory statement:

> Monetary policy in the year ahead is likely to be faced with one of its more difficult tests of the postwar period, if the forecasting judgments we are presenting today prove to be roughly on target. For while the economy is now in the middle of intense inflationary pressures and a severe squeeze in the credit markets, we think that the odds favoring a marked cooling off over the next year are quite high.
>
> Today's projection assumes that fiscal policy will stay on the restrictive course recommended by the Administration. A tight ceiling on budget outlays of $192.9 billion is implied, and we are told that the Administration puts a high priority on keeping within that total. Also, we assume that the surcharge will be extended at 10 per cent till year-end and 5 per cent thereafter, and that the investment tax credit will be eliminated. Both of these measures seem now to stand a good chance of getting through Congress, though perhaps with some delay.
>
> For monetary policy, we are assuming continuation of the current policy stance over the months immediately ahead, and then a gradual move towards less restraint in the fall, when we expect the incoming information to signal more clearly the projected economic slowdown. The timing and extent of this move towards reduced restraint are critical. Too early or too large a shift in policy could seriously injure hopes of getting inflation under control; too late or too small a move might contribute to a deeper and more prolonged setback in the economy than would be socially or politically tolerable.

Mr. Wernick reviewed nonfinancial developments as follows:

Considerable momentum is still evident in important sectors of the economy, despite the slowing in real growth over the past year. As a result, current statistics present a mixed picture of economic developments. Industrial production has been rising rapidly, and may show a 6 per cent annual rate of increase in the current quarter. Prices, too, have been moving up rapidly. Since early this year, consumer prices have risen almost twice as fast as a year ago, and widespread increases have also been registered in wholesale prices.

At the same time, retail sales have been sluggish since last fall, and the dollar volume is now running only about 3 to 4 per cent above a year ago. With prices higher, real takings have actually fallen below year-ago levels. And employers are adopting more cautious hiring policies; production worker employment in manufacturing declined slightly in April and May, following a sharp run-up earlier.

Despite these conflicting indicators, we believe real growth in the economy will slow further. The sluggish pace of Federal purchases and consumer buying since last summer, together with the unusually high costs and limited availability of borrowed funds, appear to be affecting business decisions in important ways.

Thus, the most recent Commerce-SEC survey points to a marked slowing in plant and equipment spending during the last half of this year, and this seems to be confirmed by the trend of new orders. With the investment tax credit assumed to be eliminated, and the imbalance between output and available capacity worsening, we expect the slowdown to turn into an actual decline early next year.

We are projecting business fixed investment to be falling at an annual rate of 8 per cent by the second quarter of 1970. This would be a bit steeper than the decline in early 1967, but it is not as severe a drop as in the 1957 recession.

A slower pace of business fixed investment would increase the prospects for an inventory correction. For durable goods manufacturers, inventory-to-sales ratios have been hovering at about the level they reached at the end of 1966--prior to the inventory adjustment of early 1967. Recent stock-sales ratios, however, have been moderately below those reached at the upper turning points of the 1957 and 1960 cycles. But if final sales weaken, these ratios could rise rapidly, as they did in earlier periods of slowing demands, inducing businesses to cut back production and orders.

We are not, however, projecting a decline in inventory investment until after the fourth quarter of 1969. Inventory investment in the third quarter of this year is expected to stay at about the first-half rate, and then to rise a little in the fourth quarter as final sales slow materially. In the first half of 1970, inventory investment should drop substantially as businessmen attempt to trim excess stocks.

This pattern of change would resemble the 1957 experience, when the rate of inventory investment remained fairly steady until the cycle peak, and then dropped sharply.

The large jump in inventory investment late in 1966 and the steep decline thereafter is not a typical cyclical pattern. Such large changes in the rate of inventory investment seem unlikely to be repeated.

As Mr. Partee noted, we assume that the fiscal restraint program proposed by the Administration will be adopted. The tight budget ceiling implies that Federal expenditures on the national income accounts basis will show only a slow rise following the Federal pay increase in the third quarter. In fact, a slight decline in defense expenditures is anticipated after the third quarter--a pattern that seems consistent with recent order trends and announced troop deployment in Vietnam.

Federal receipts are projected to show little further growth this year, reflecting completion of retroactive tax payments, and then to decline somewhat in the first half of next year, because of slower income growth and the assumed reduction in the surcharge to 5 per cent on January 1.

The budget surplus should therefore decline a little after midyear, and a small deficit is projected for the first two quarters of 1970. However, much of this swing to deficit reflects the slowdown in economic expansion. On a full employment basis, using the third quarter of 1969 as a base, the budget would still be showing a moderate surplus in the first half of 1970.

Turning to the consumer sector, it is now quite clear that higher taxes since mid-1968 have tempered growth in consumer expenditures, as well as in disposable income, even though consumers have reduced their savings rate appreciably.

Over the next year gains in consumer expenditures are projected to be moderate, with the average quarterly increase below the first quarter of this year. The dampening effect on disposable income of reduced overtime work and declining employment is the most important factor limiting growth in consumer outlays. While the Government pay raise just ahead and the reduction in the surcharge on January 1 will make important additions to income, the impact on spending should not outweigh the effects of slower growth in wages and salaries.

On balance, there appear to be few remaining sources of strength in the economy, and there is, therefore, a strong possibility of a considerable slowdown in GNP growth over the next year. The weakness should become evident later this summer, after the Federal pay raise has given a temporary fillip to retail sales in the third quarter, and growth in GNP should fade to about $11 billion in the fourth quarter. Next year, the reduction in the surcharge may help to sustain consumer buying, and residential construction could pick up as competing uses of funds moderate. Nonetheless, these factors seem far too weak to offset dampened business spending and the multiplier effects on income and consumption. We expect that gains in GNP will drop to a $6-7 billion range by mid-1970.

Translated into real terms, GNP growth would recede to about a 1 per cent annual rate in the fourth quarter of this year, and then come to a standstill in the first half of 1970.

If growth in the economy follows the projected path, resource requirements could be expected to ease appreciably. Capacity utilization is projected to fall significantly by mid-1970, reflecting both a decline in industrial output and continued additions to capacity. Businessmen should find it increasingly difficult to pass on cost increases to higher prices as available capacity becomes excessive.

Demands for manpower have already begun to moderate somewhat--employment gains have slowed and unemployment has started to move up slightly in recent months. In the year ahead, our GNP projections imply rising layoffs and a labor force growth that is close to a normal pace. Consequently, unemployment is projected to increase to 4 per cent by the end of this year and to slightly over 4-1/2 per cent by the middle of next year.

Even with some easing in labor market pressures, wage increases are likely to remain large as workers bargain hard to hold down erosion in real earnings. Consequently, we are not expecting much slowing in the rate of increase in hourly earnings in manufacturing before early 1970. Negotiations are expected to be extremely difficult next year when many major labor contracts are reopened.

However, past experience does suggest that the rate of wage increases will diminish if the slowing in aggregate demand is maintained over a period of time. Thus, in 1956 and early 1957, wage increases slowed and then fell off substantially in the four quarters after the downturn. By contrast, during the short-lived inventory adjustment after the fourth quarter of 1966, wages continued to advance fairly rapidly and then began to accelerate.

Because productivity growth typically slows in a recession, unit labor costs continue to rise long after the cycle peak--they reached a high in early 1958 and again in early 1961, at the bottom of the recession. After a prolonged period of stability from 1961 to the end of 1965, unit labor costs began to move up sharply, and the rise did not slow after the 1967 inventory adjustment.

Over the long pull, unit labor costs and industrial commodity prices move together, but industrial prices respond more quickly to changing economic demands. In each of the recent periods of economic slowdown industrial prices leveled off, although unit labor costs kept rising. We expect this pattern to be repeated in the year ahead--with unit labor costs continuing to increase sharply for a while, but some slackening developing in the industrial price rise.

The GNP deflator is much less responsive to changes in the rate of real GNP growth, because food and services weigh heavily in that index. Nevertheless, with varying lags, over-all prices also have responded to easing in economic activity. Thus, in the 1960-61 recession, the rate of increase in the price deflator did not taper off appreciably till the recession was nearly over. In early 1967, by contrast, the deflator responded fairly quickly and sharply to the drop in GNP growth.

In the current period, gains in real GNP have already moderated significantly, and are expected to decline substantially further over the next year. While the rate of increase in the deflator should moderate, as it did in late 1957 and 1958, it may be some time before significant progress is seen in cooling inflation.

Mr. Gramley presented the following analysis of financial developments:

Private nonfinancial borrowers have raised enormous sums in the credit markets since mid-1968; their borrowing during this past year has amounted to over 11 per cent of private GNP expenditures. But monetary restraint this year has changed credit costs and availability substantially, and we expect a significant decline in private borrowing in the second half of 1969.

With GNP growth projected to moderate over the projection period, private borrowing should remain relatively low in the first half of 1970--assuming, as we do, that a massive rush for liquidity such as occurred in 1967 will not happen again.

Total Federal borrowing, including the borrowing of quasi-governmental agencies, should turn up again soon, as loan programs continue and the NIA budget shifts to a small deficit in early 1970. But the total of funds raised is projected to remain well below recent peaks, when both Federal and private demands were larger than we are projecting for the year ahead.

In the economic climate envisaged, market forces would be expected to exert downward pressures on interest rates--and perhaps rather strong pressures, since currently high rate levels reflect inflationary expectations. Once it becomes clear that excess aggregate demand will not continue, investor willingness to acquire fixed-income securities could increase markedly.

At many times in the past, interest rates have seemed to us the most appropriate guides for monetary policy, and the best available indicators of financial conditions. But in the projected economic environment, it is not clear how much rate decline would be needed for consistency with our GNP projection, since borrowers, too, will be reconsidering their calculations of investment profitability as economic and inflationary expectations change. With both borrower and lender attitudes changing, how far or fast the interest rate decline should go is difficult to quantify with precision.

Accordingly, although the level and structure of interest rates must continue to be important factors in assessing the course of policy, the chances of serious error might be reduced if, over the next year, relatively more emphasis were to be placed on quantitative targets in setting a longer-run course for monetary policy.

The question of which quantitative target should be selected, however, is not easy. Bank credit, money supply, and reserves are three leading candidates for selection as policy targets over the longer run, and the choice among them is not a matter of indifference.

Interpreting changes in bank credit growth has become increasingly complex in recent years. For example, during the first five months of 1969 the credit proxy adjusted for Euro-dollar borrowing declined at more than a $2 billion annual rate. The unadjusted credit proxy declined a good deal more. The arithmetic of adjusting the proxy for Euro-dollar borrowing is simple, but its analytic implications are not. An increase in bank credit due to additional Euro-dollar borrowing does not add to the public's holdings of deposits. Its effect on credit markets is not the same as an increase in bank credit resulting from open market purchases by the System, which do generate additional deposits and increase liquidity.

And what should we make of the wide swings in bank credit growth attributable to the volatility of large-denomination CD's? We certainly cannot ignore them; indeed, the effects of CD ceilings on bank liquidity have played a major role in the timing and sectoral distribution of the impact of monetary restraint. But since CD's are so much like market securities, and the demand for them is so interest sensitive, variations in CD's do not have the same meaning as changes in the growth of other deposits. Of course, recent innovations by banks to obtain funds through channels that are not reflected in bank balance sheets have made bank credit growth even more difficult to interpret.

The most recent innovations in banking probably have had less effect on the interpretation of the money supply than on bank credit as an indicator of policy. But the money supply has important drawbacks as a policy target during a period of slow economic growth. A comparison of the relative growth of reserves and money during the recession of July 1957 to April 1958 illustrates the problem.

Reserves and the money stock sometimes follow different paths in such periods, because the public may choose to hold the additional deposits supported by reserve growth in the form of time accounts.

In that recession, bank reserves grew a bit more than 2 per cent, but the money stock did not rise at all--probably reflecting the sluggishness of transactions demand. Additions to reserves over this period produced a substantial rise in commercial bank time deposits, however. A similar disparity between reserve provision and money growth occurred in the recession of 1960-61. In the mini-recession of 1966-67, on the other hand, movements in the two series conformed rather closely.

It seems to us, on balance, that total reserves might be the quantitative target least likely to misdirect the over-all course of policy during the period ahead. If monetary policy were guided over the longer-run by a variable growth rate of total reserves, there would seem to be little basis for being overly concerned about the resulting distribution of deposit growth between demand and time accounts.

How much reserve growth should be provided, given our GNP projection, is a difficult question. There are many links between reserve provision and private spending decisions, and our knowledge of them is imperfect. It does seem clear that the negative growth rate of the first half of 1969 should not continue for long. We believe that the posture of monetary policy will need to move gradually towards an expansion rate suitable for longer-run economic needs; that is, to somewhere around a 4-1/2 per cent annual rate by the first half of 1970. We assume, also, that a resumption in reserve growth would be needed before this year is over, and that this need will be more clearly indicated by economic developments as the year progresses.

Given the projected rates of reserve expansion and GNP growth, interest rates should begin to drop later this year, and fall further in the first half of 1970. Though our estimates here are highly uncertain, it seems to us that bill rates might drop to around 5-1/4 per cent by the second quarter of 1970. If economic growth proved to be weaker than projected, bill rates might decline further, and consideration would then need to be given to liberalizing the reserve targets just discussed.

The accompanying decline in long-term rates would depend on expectations of both investors and borrowers. Downward movements are likely to encourage an increased volume of municipal security offerings, and yields on high grade municipals might fall only moderately, to a range around 5 per cent. We are expecting less supply response in the corporate market, so that the Aaa new issue rate might fall relatively further, perhaps to a range around 6-1/2 per cent. Mortgage rates will probably experience only a little easing over the year ahead, given the underlying strength of demand for housing.

In fact, in the immediate future, some further tightening of mortgage money seems foreordained by the outlook for nonbank savings accounts. Growth in these accounts during the first half of 1969 amounted to little more than would be accounted for by the crediting of interest to existing deposits. We expect currently high market interest rates to produce a sizable further erosion during the summer and early fall, but with a recovery later in the year holding the annual growth rate to about 4-1/2 per cent for the second half as a whole. If rates on market securities decline later this year and in 1970 as projected, rates of savings inflow should show a modest upturn to about the 1968 pace in the first half of next year.

As noted earlier, we are uncertain about the response of the money stock to the projected rate of reserve injection, given the assumed pattern of GNP growth. As a rough estimate, monetary growth might remain at around a 3 per cent annual rate in the second half of this year. In the first half of 1970, transactions demand for money should ease, in line with slower GNP growth, but if interest rates decline as projected, the increase in the money stock could rise moderately to about a 3-1/2 per cent rate.

Time deposit growth is expected to rebound from the negative growth rate thus far in 1969, which has resulted from a sharp run-off of CD's and a diminished rate of expansion in other time deposits. This projection is also surrounded with uncertainty, however. Much depends on bank adjustments in the CD market, in the Euro-dollar market, and in the new markets opened this year. Our best guess is that time deposit expansion might return to a 6 per cent annual rate in the second half of 1969, and then rise to an 11 to 12 per cent rate in the first half of next year.

Basically, what we are projecting is a return to growth rates of money and time deposits that seem consistent with the economy's longer-run requirements, as best we can evaluate them. The banking system probably would wind up supplying about one-third of total funds raised--not a high figure by historical standards. Thus, our projection does not imply a switch to high rates of monetary expansion such as occurred in late 1966 and early 1967.

Mr. Hersey presented the following analysis of the balance of payments:

In rereading our chart shows of the past two years, I found a persistent over-optimism about prospects for the U.S. trade balance that appalled me. But I also found a chart on unit labor costs with a chilly message. We noted that unit labor costs in U.S. manufacturing in the spring of 1968 were already 9 per cent above the level maintained from 1959 to 1965, and the chart projected a continuing rise--close to what has actually happened. By now the rise is 13 per cent. In Germany, by way of acute contrast, unit labor costs in industry were no higher at the end of 1967 than in late 1965, and since then they have been virtually stable-- as productivity has kept pace with accelerating wage advances. This divergence makes last May's non-event of a mark revaluation seem a very desirable future event. Whatever the United States may hope for in the way of measures of adjustment by other countries, our own due contribution to international equilibrium and stability cannot be made if U.S. costs and prices continue rising at their post-1965 pace.

In reassessing near-term prospects, we first take note of the state of demand abroad. Since early 1966 (just before the start of a recession in Germany), German industrial production has risen, net, by one-fifth. In Germany and in many other countries, margins of unused resources of labor and capital by now have become quite small. The boom abroad was given a push by the spillover of U.S. demand, but by now it has become self-generating. In Britain, however, the growth of activity has been slowed by measures to restrain domestic demand in the interests of a better external balance.

In the United States, ten years ago, the combination of tight fiscal policy and a very tight monetary policy, plus a long strike in the steel industry, were putting an end to the wave of inflation that rose in the mid-1950's. Abroad, after a pause in 1957 and 1958, industrial activity was rising rapidly in 1959. The next year, 1960, demand abroad continued very strong while a mild recession set in here.

Now once again we are aiming for stabilization. In the twelve months ahead, the continuing strength of demand abroad, apart from the United Kingdom, may again be expected to serve as a counter-weight to the cooling off in the United States, diminishing the risks of a worldwide recession and helping to maintain the rising trend in U.S. exports.

After the U.S. trade surplus had practically disappeared in the spring of 1959, it widened again during the mild U.S. recession of 1960 and early 1961, partly as a result of rising exports and partly through a sharp fall in imports. In the period ahead, after we get past the dock strike distortions, we do not expect as much improvement in the trade balance as in 1960-61, because imports are not expected to fall. Exports, however, will probably rise more than imports.

In 1960-61, imports both of materials and of finished goods fell off. Contributory factors were the ending of the 1959 steel strike and the competition the new compacts were giving foreign cars. More generally, U.S. demand for many kinds of imports eased off. In the period ahead, finished goods imports may continue to rise. Foreign suppliers seem to be able to hold their export prices down even while their own domestic price levels rise, and advances in U.S. prices in recent years have made imports more attractive than ever. The relative importance of finished goods among U.S. imports has risen markedly in the past decade, making it all the more likely that total imports will rise further in the coming period.

I hope we are not being too optimistic again in looking for a small recovery in the balance on goods and services to something like a \$3-1/2 billion rate by mid-1970. This would still be far short of the 1966 balance which was \$5-1/2 billion, and way, way, below the $8 billion peak reached in 1964. Our projection assumes little change in the net balance on services. The improvement will be mainly in the merchandise trade balance.

The published liquidity balance and the adjusted over-all balance have been heavily in deficit during the first half of 1969. Partly this has reflected unusually large unidentified outflows, presumably into German marks and Euro-dollars. Looking ahead, we assume that the abnormal outflows will not be large on balance over a 12-month period. But the trade improvement may be offset by shrinkage in some capital inflows, and over-all deficits are likely. On the official settlements basis, the large surplus in the first quarter has been followed by a near-zero balance in the second quarter, and substantial deficits could emerge later on. The difference between the official settlements and the adjusted over-all balance is the inflow of interbank borrowings, including those from the foreign branches of U.S. banks, and this inflow may be reversed later on.

Among the capital inflows likely to be smaller than before, a principal example is foreign buying of U.S. stocks. After running for several months at an average annual rate around $3 billion, these fell off to a rate under $1 billion in March and April.

The current picture regarding U.S. corporate outflows for direct investments in subsidiaries, short-term investments, and commercial credits is obscure; the $5 billion annual rate estimate for the first half of 1969 is a rough guess that allows for some sizable movements into German marks and Euro-dollars. For the following twelve months we project some liquidation of short-term holdings but a relatively large direct investment flow, so that the net total outflow may be almost as large as in 1968. However, the use of foreign funds from U.S. companies' new borrowings abroad may be much smaller than in 1968, and the use of U.S. funds would therefore be larger. For one thing, the pressures put on companies by the control program are less severe than they were in 1968. For another, European financial markets may be less receptive.

As you well know, a marked shift in interest rate relationships has taken place since 1966. In Britain, as in the United States, long-term rates started rising again in 1967, while German rates continued to decline until March of this year and since then have moved up a little. No one can predict where German rates will be a year from now.

The shift in interest rate relationships has of course reflected monetary policy decisions, in turn greatly influenced abroad by balance of payments considerations. German short-term rates, even after increasing since a year ago, are still relatively low--especially when judged in the light of signs of inflationary pressures in the German economy. Meanwhile, Euro-dollar rates have reached astronomical heights. The pressures on national money and capital markets, as well as on official foreign exchange reserves, that tightness for Euro-dollars generates, are a cause of concern for some continental European central banks. British money markets did not tighten further in June.

The buildup in liabilities of U.S. banks to foreign branches and other foreign commercial banks was $3 billion in the first quarter of 1969. Temporarily there was a reverse flow when funds were moving into German marks, but the net inflow in the second quarter is apparently exceeding $3 billion--or perhaps even $4 billion. Supplies of funds have been attracted from at least three main kinds of sources. Short-term investors have moved out of marks on a large scale, protected by forward cover sold by the German Federal Bank. Some borrowers of Euro-dollars, other than U.S. banks, have refinanced elsewhere. And indirect evidence suggests that since February dollar investors have been moving from the United States into Euro-dollars on an increasing scale.

Despite the adjusted over-all deficit totaling $10 billion in the two-year period since mid-1967, U.S. liquid and near-liquid liabilities to foreign official reserve holders have decreased on balance, as a result of the sharp rise in the liabilities to banks abroad. The growth of liabilities to official holders was held down also by the large U.S. gold sales in 1967 and 1968. On the other hand, the increase in Federal Reserve and other U.S. official holdings of foreign currencies has tended to enlarge the reserve liabilities. Looking ahead, if the adjusted over-all deficit in the next twelve months amounts to something like the $4 billion we have projected, and if U.S. reserve assets decline moderately, our liabilities to foreign official reserve holders will increase sharply if there is no further increase in the interbank liabilities, and still more sharply if these decrease. To maintain inter-central bank cooperation under such circumstances, it will be important for the United States to show progress toward stabilization.

Mr. Partee concluded the presentation with the following comments:

Our GNP projection for the year ahead shows more similarities to that of a year ago than we care to remember. The mid-1968 projection, as the Committee well recalls, under-estimated significantly the expansive forces in the private economy, and there is a chance--though we think it is an outside one--that this could be true again. A major breakthrough toward peace in Vietnam, for example, could have bullish short-run economic implications which we haven't assessed here. And inflationary expectations might be so deeply entrenched that the effects of traditional economic stabilization measures would continue to be blunted for a while. Nevertheless, we are impressed by the fundamental changes taking place in the economic situation over the past 12 months.

The most important difference relates to business fixed investment. A year ago we were on the threshold of a sharp surge in plant and equipment expenditures that partly offset the restraining effects of the new fiscal program. The upswing proved to be a major source of continuing pressures on resources and prices. Now we seem to be in for a significantly slower growth rate over the last half of this year, and--when the investment tax credit suspension really begins to bite in early 1970--a decline seems fairly probable. In part, this change in trend reflects the delayed effects of last year's fiscal restraint program finally carrying through to business spending plans. But this is being reinforced by an extremely taut monetary policy that has raised credit costs sharply further, and has reduced fund availability substantially in recent months.

In the housing area, the strength of underlying demands that boosted starts to a 1.7 million annual rate in the first quarter of this year is, if anything, intensifying. But starts have already begun to fall, and a further decline in the months ahead seems almost certain, given the additional recent tightening in the mortgage market. But we are still hoping that the downturn in starts and expenditures will remain modest, and the projection calls for renewed expansion by the first half of 1970, predicated on some easing of money and capital market pressures.

Given the mixed evidence on current economic developments that Mr. Wernick presented earlier, it would seem to me too risky to recommend a major shift toward monetary ease now to cushion the economic weaknesses projected for later this year and early 1970. Industrial production _is_ still rising at a 6 per cent annual rate, and prices _are_ still rocketing upward. I am reasonably confident that our GNP projection is in the right ballpark, but there is still relatively little confirmation of it in the current indicators. Until more solid evidence of impending weakness appears, the severity of the inflationary problem dictates caution in policy actions.

Our balance of payments position indicates the need for caution also. We are enjoying a surplus on the official settlements basis so far this year--but only by virtue of a massive inflow of Euro-dollars. The deficit on a liquidity basis was huge in both the first and second quarters. There is some hope for an improvement over the next year, but even so the projected rate of deficit would still be too large.

The achievement of fundamental improvement in our payments position will be a slow, hard process. Monetary policy may not be able to wait before moving to see that such improvement has been set in train. But the balance of payments situation does argue strongly against changing policy more quickly or aggressively than is clearly required by domestic developments.

For the longer run, the policy strategy we are postulating calls for a moderate shift towards an easier posture of monetary policy some time this fall, to permit growth in total reserves to resume at a 2-1/2 to 3 per cent annual rate during the second half. The timing of such a move should be dictated by the incoming economic data, and we believe that it will be warranted by early autumn. If the economy subsequently shows the weaknesses that our projection envisages, a step-up in reserve growth to about a 4-1/2 per cent annual rate during the first half of 1970 would then seem reasonable.

Such a switch in policy would be much less pronounced than what occurred during the 1966-67 mini-recession, when total reserves increased by almost 10 per cent for the full year 1967. In fact, a 4-1/2 per cent rate of reserve expansion may be no more than what is needed over the longer run to sustain full employment at relatively stable prices. The moderate character of the suggested policy response reflects our concern with the problems that would be posed by continued inflation and large balance of payments deficits, and also the desire to get out of the pattern of "stop and go" monetary policy of recent years. Of course, if economic weaknesses develop along a considerably wider front than we have projected, greater monetary stimulation would be needed.

We would, moreover, suggest that consideration be given to suspension of Regulation Q ceilings on large-denomination CD's around the end of this year, if interest rates on Treasury bills and other short-term market securities decline as projected. The existence of this ceiling has at some times been ineffective in limiting CD sales, and at other times much too effective. The result has been alternating periods of massive liquidity accumulation and runoff by the banks--fluctuations that do not seem to have contributed to financial and economic stability. Indeed, since there always has been a hope in bankers' minds that the ceilings would be raised when the going got rough, Regulation Q ceilings may even have delayed adjustments in bank lending policies during periods of monetary restraint, then followed by undesirably sharp adjustments when the necessity of cutbacks finally became clear. If we can assure banks that the CD market will be viable over the longer run by suspending the ceiling at the next opportunity, this may help to moderate the rush of banks into CD's as market interest rates decline, and might help dissuade banks from developing further the wide variety of nondeposit sources of funds that currently are posing regulatory problems.

In the interim, consideration might be given to raising ceilings rates on large-denomination CD's by, say, 50 to 75 basis points for maturities of 3 months and longer. Under existing ceiling rates, and assuming short-term market rates at about current levels over the next several weeks, extreme pressures on liquidity positions of many banks will continue and could intensify. And it is worth noting that the CD drain we have seen this year goes well beyond the largest money market banks in New York and Chicago. Other weekly reporting member banks have lost about 20 per cent of their CD's since December, in contrast to 7 per cent in the 1966 squeeze.

The result has been a sharp decline in liquidity ratios this year--that is, in the ratio of liquid assets to total liabilities less capital accounts--at both New York banks and other weekly reporting banks. These ratios are now at or below their 1966 lows. While effective constraints on bank lending are clearly necessary to combat inflationary pressures, there may now be a real danger of a precipitous change in credit availability, with effects on particular markets that could be too harsh and too abrupt. The modest interim adjustment suggested for the Regulation Q ceiling would reduce attrition over the near-term, but probably would not eliminate it completely. Thus, continued pressure on liquidity would keep the banking system on a very tight rein.

For the near term, the problem is one of steering a course of monetary policy that keeps enough pressure on banks and the financial system to ensure that a further slowdown in GNP growth does occur. Until that is more certain, we believe that monetary policy should stay close to the stance that has been achieved, while permitting the intense financial pressures that built up over the tax period to continue unwinding. This would probably imply, for the weeks immediately ahead, a Federal funds rate around 8-1/2 per cent, and a 3-month bill rate fluctuating widely in a 6-1/4 to 6-3/4 per cent range, but probably averaging somewhat below recent peaks. Consistent with these interest rates is a net borrowed reserve figure that would remain a little deeper than $1 billion.

Since short-term interest rates have risen sharply further in recent weeks, discussion of another discount rate increase has come to the fore. An increase would be consistent with market developments, but there is no evident need for an overt signal that monetary policy is tight. And since the discount rate is already far out of line with most short-term interest rates, without any obvious ill effects, the question of whether or not it is raised again at this time seems to me almost entirely a matter of public posture. Perhaps a one-half point increase could be linked

> with a similar rise in large-denomination CD ceilings, with the combined move suggesting on balance neither further tightening nor ease. But in any event, I urge strongly that there be no further appreciable intensification of restraint at this critical juncture. If our GNP projection is approximately correct, the next major move that the Committee will be considering lies in the direction of easing off somewhat from the present monetary posture.

Chairman Martin said that, in order to permit everyone to participate in the go-around on the same footing, he wanted to inform the Committee about certain policy matters which the Board of Governors had under consideration. Three Reserve Banks had taken action to increase the discount rate, with two Banks proposing an increase of 1 percentage point and the third Bank an increase of 1/2 percentage point. The Board had been discussing possible regulatory amendments to restrain the use by banks of certain nondeposit devices to raise funds--most particularly, Euro-dollar borrowing, but also repurchase agreements against bank loans, issues of securities by bank holding companies, and Federal funds transactions involving nonbank customers. An increase in Regulation Q ceilings on large-denomination CD's had also been suggested for Board consideration. Expressions of views on those matters in the course of the discussion would be welcome.

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

The price situation is bad, and inflationary psychology remains strong. There are few signs of an immediate further slowing in the pace of economic expansion. Yet there are some factors pointing the way, such as sluggish retail sales, a modest downward tilt in housing, a modest reduction in expected capital expenditures, and probable growing pressure on profit margins. Real growth has been at a rate of about 3 per cent this year compared with over 6 per cent a year ago.

The balance of payments situation continues to be discouraging. The trade balance in 1969 is likely to produce no more than a small surplus. The course of inflation at home will have an important influence on our trade balance. On the capital side, purchases by foreigners in the U.S. stock market have declined from last year and the prospects for capital inflows through portfolio purchases are cloudy. The bulk of the recent abnormal capital outflow in expectation of a revaluation of the German mark has not been reversed. The Euro-bond market is no longer an attractive source of funds for foreign subsidiaries of U.S. corporations.

It appears likely that the Federal budget will show a modest surplus this fiscal year. It's good to see even a modest surplus, but current economic conditions call for a greater surplus. Nothing can be done now about the current fiscal year, but something can be done about the coming fiscal year. An extension of the income tax surcharge is essential. To let it lapse would be irresponsible. The favorable report of the House Ways and Means Committee is encouraging, but the surtax extension is not yet law. The course ahead is still delicate. In my opinion, we need more than a mere extension of the surtax. Unless there are real reductions in expenditures, next year's surplus is not likely to be large enough, particularly in light of the expected expansion of extra-budgetary financing by Government agencies. The chances are that fiscal policy will play a modest part in fighting inflation, and that monetary policy will continue to bear the major burden.

The rate of growth of bank credit and the money supply has been moderate. Over all, bank liquidity has declined significantly; it is very low for most money market banks. The savings banks and savings and loan associations are concerned about a curtailment in the growth of deposits, but so far the situation seems to be under control. The sale of a number of municipal issues has been postponed or canceled and the cost of municipal financing is very high. Corporate market borrowing has continued at high rates.

The banks have increased their Euro-dollar takings enormously over the last few weeks, and Euro-dollar rates at one time exceeded 13 per cent. A number of foreign countries have taken action of one kind or another to defend themselves against the adverse effects on their markets caused by such high Euro-dollar rates and other rates. We cannot be unmindful of the effect abroad of monetary restraint in the United States.

The recent increase in the prime rate from 7-1/2 per cent to 8-1/2 per cent is evidence of the increased intensity with which banks are feeling the current monetary restraint. It is clear, however, that merely increasing the cost of money, taken by itself, will not bring about an adequate reduction in the demand for credit. Banks will still have to be much more selective in making loans; the increase in the prime rate is not a substitute for rationing credit.

The much-heralded "super crunch" failed to materialize. The possibility of severe monetary strains over the mid-month tax-payment date was talked about and feared so much that people adjusted for it. The absence of a crunch, as the tax date came and went, attested to the care and attention with which financial institutions and business corporations planned their affairs over the period.

While we have passed the mid-June tax date satisfactorily, the end of June and the fourth of July weekend customarily bring market pressures. Thus, we can expect continuing uncertainty and caution.

The banks have sought with vigor and great ingenuity to devise new ways to get funds to meet loan demand. As new ways have been developed and expanded, various statistical series have become less meaningful. For example, the expansion of cash items in process of collection in connection with Euro-dollar transactions has reduced demand deposits by perhaps as much as $3 billion. Correction of the loophole would immediately bring a large increase in the statistical measurement of the money supply, and of course an increase in required reserves.

The strength of the economy and the prevailing inflationary psychology, in my opinion, counsel a continuation of about the same degree of monetary pressure. In considering appropriate open market policy to promote this result, we must bear in mind the various techniques employed by commercial banks to raise funds outside the scope of Regulations D and Q, and the possibility of System action to curtail such techniques.

Mindful of the need for cutting down on the availability of credit, it seems to me that there is merit in pursuing a series of measures directed toward reducing or eliminating the use of these other sources of funds. Caution in the timing of the measures will be needed to avoid an undue concentration of the resultant pressure.

The noncompetitive deposit rate ceilings under Regulation Q have played a major role in the development of many of these techniques. Elimination of the ceilings or an increase in the ceilings, particularly the ceiling on large-denomination CD's, presumably would lessen the incentive to resort to such techniques. A number of foreign central banks have urged such action as a means of relieving the pressure on the Euro-dollar market. But any liberalization of Q ceilings would at best dampen the incentive to cultivate these newly developed sources of funds. The incentive would not be eliminated in this period of restrictive credit policy, particularly where Regulation D can be avoided as well as Regulation Q.

I fear that an increase in the maximum permissible rate on large-denomination CD's to, say, 7-1/2 per cent or 8 per cent would likely result in the effective rate on CD's rising to the new maximum. As banks obtained more funds by this route and increased their intermediation function, is it likely that they would be as selective as they now must be in making loans, especially business loans? My answer would be in the negative.

A relaxation of Regulation Q would probably be interpreted by many, if not most, observers as a retreat from the present degree of intensity of monetary restraint. At the same time, I would expect that market rates in general would rise considerably. A substantial adverse effect on thrift institutions and home mortgages could easily be envisaged. One cannot be unmindful of the social and political implications of such a development. I am not persuaded that there are clear advantages to liberalizing Regulation Q now that would outweigh the disadvantages that are so apparent.

Last September the Board of Governors announced a proposal to bring under Regulations D and Q certain funds obtained by banks from a transfer of assets under repurchase agreement. This proposal could be made effective on short notice. It would have a restraining effect, putting pressure on the banks to be more selective in making loans.

The recently announced proposal of the Board to amend Regulation D to plug the loophole with respect to cash item deductions in connection with Euro-dollar transactions could be made effective shortly after the mid-July date that was specified as the deadline for the receipt of comments.

High priority should be given to the Euro-dollar market. It is a large source of funds to the major banks; their takings have grown rapidly and serious pressures have resulted on European financial centers. I would favor action by the Board placing a meaningful reserve requirement on that portion of the borrowings by a United States bank from its foreign branch, or any other foreign source, that exceeds the level of such borrowings on a recent base date. Such action would be well received abroad as recognition of the need, and of our desire, to avoid undue effects of United States monetary restraint on foreign financial markets. At home such action should be interpreted as recognition of the need to contain what seems to have become more of an escape hatch than a safety valve for the big banks.

With respect to bank-related commercial paper, it should be possible to include in the definition of deposits under Regulations D and Q obligations issued by a bank affiliate where the proceeds of the obligations are used to purchase assets from the bank or are lent to the bank. I would favor an announcement of such a proposal by the Board in the not too distant future. The details of the proposal would require careful work within the System, and there should be ample opportunity for those outside the System to comment.

Open market operations may be called upon to cushion adjustment incident to these various actions by the System, but open market operations shouldn't offset the actions. Taken together, open market operations and the actions should keep up the pressure of monetary restraint.

The 6 per cent discount rate is out of line with other rates. Yet, we have had no serious problems in the administration of the discount window at the Federal Reserve Bank of New York. Thus, we see no need for an increase for administrative reasons. I think an increase would be unwise while the course of the surtax extension continues to be delicate. An increase could easily exacerbate tensions in the Euro-dollar market over the mid-year. Further time should be taken to assess the present situation which is likely to continue in strain over the remainder of the month. Having raised all these caveats, I am, nevertheless, inclined to think that an increase of perhaps 1 percentage point in July may be appropriate. But, of course, any decision will have to be made in the light of circumstances as they unfold.

Looking to open market operations in the forthcoming weeks, I think they should confirm a continuing policy of restraint. Such confirmation might be evidenced by member bank borrowings between $1 and $1-1/2 billion; net borrowed reserves between $900 million and $1.3 billion; and a Federal funds rate in a range of 8-1/2 to 9-1/2 per cent.

To summarize, I would favor continuation of our present policy of monetary restraint, reinforced by restrictions on various fund-raising devices developed by the banks to avoid or reduce the direct impact of monetary restraint. I would be inclined to favor an increase of 1 percentage point in the discount rate in the not too distant future. I would not favor any change at this time in Regulation Q ceilings.

As for the directive,1/ the first paragraph of the draft submitted by the staff is acceptable. I don't see the need to make the suggested change in that part of the second paragraph that precedes the proviso clause. Indeed, I think there is some advantage in retaining the word "pressure", which is used in the present directive in the context of "maintaining the prevailing pressure on money and short-term credit markets." The proposed change in the proviso clause, to add a reference to unusual liquidity pressures, is satisfactory.

Mr. Morris said that the events of the past two weeks suggested to him that the restrictive monetary policy of the past seven months was beginning to produce results. The most impressive piece of evidence was the precipitous decline in common stock prices. Since the primary source of new expansionary force in the economy during the last nine months had stemmed from the inflationary psychology of the

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

businessman and the investor, a deflation of common stock prices was the signal he had been looking for that attitudes were in the process of changing. That signal had been a long time in coming, but he believed its appearance represented an important turning point. He thought the probabilities were high that, when the data for June became available, a general weakening would be evident in the other leading indicators--following the pattern of slight decline in those indicators in May.

Mr. Morris thought there was no basis in the current economic statistics for changing policy, but there were ample grounds for thinking that the current policy was producing results. Under those conditions, he thought the Committee should seek to maintain approximately the current level of monetary restraint. But that was going to be difficult to accomplish, since the momentum of the market would probably work to intensify the level of restraint.

Mr. Morris commented that after reading the blue book it was clear that it would be very difficult for him to define precisely what was meant by "maintaining the current level of restraint." He would certainly accept the money market conditions and the marginal reserve measures described in the blue book,[1/] and he

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1/ The passage in the blue book referred to read as follows: "Given the shifting locus of market pressures, a generally unchanged set of money market conditions over the next three weeks may include a Federal funds rate fluctuating around 8-1/2 per cent, member bank borrowings in a $1 - $1-1/2 billion range, and net borrowed reserves averaging a little over $1 billion. The 3-month bill may fluctuate widely, perhaps in a range as wide as, or wider than, 6-1/4 - 6-3/4 per cent."

thought the liquidity proviso the staff had suggested for the directive was well advised for the period ahead. On the other hand, he was concerned that the prescribed money market conditions were expected to require the banks to pull in up to an additional $1 billion from the Euro-dollar market in order to avoid a further contraction of bank assets.

In such a dynamic situation, Mr. Morris continued, it was clear that the Committee would have to leave much to the discretion of the Manager. However, he thought the Committee should make clear to the Manager whether it was seeking to maintain the current level of tension in the market or whether it was willing to let the momentum in the market generate increased tensions.

Mr. Morris noted that there had been a great deal of concern in the System about what might be called the "leakages" from monetary policy. Apart from the equity considerations involved, he thought the concern might have been exaggerated. The access to the Euro-dollar market and the other devices which the banks had used to soften the impact of policy had permitted the banking system to adjust in an orderly way to a very restrictive policy. As a consequence, over the past seven months there had been a leveling off of bank credit rather than the absolute contraction that otherwise would have occurred; but in his opinion that was the sort of result which the Committee should have been aiming for at the outset. In any case, events were moving so rapidly that by the time the legal staff had gotten around to devising means for closing all the loopholes the need might have passed.

Mr. Morris observed that pressure was being exerted to lift Regulation Q ceilings for large deposits, both for international and for domestic reasons. Despite the fact that Regulation Q left much to be desired as a policy tool, he thought that step should be resisted. It would have a most unfortunate impact on market psychology just at the very time when the System was determined to produce a change in psychology. He agreed with the staff, however, that an adjustment in Q ceilings should be made once the current period of tension was over.

Mr. Morris said he had made an informal survey of nonbank opinion in the Boston area on the subject of Regulation Q ceilings. The general view which he had encountered among nonbank investment people and academicians was that any lifting of the ceilings would be interpreted as "throwing in the towel just when we had the banks on the ropes." The System had framed its current policy around the Regulation Q ceilings, and despite the inadequacies of that approach he thought it now had to stick it out.

Mr. Morris indicated he found the staff directive acceptable provided that it was interpreted to mean that the Committee was seeking to maintain about the current level of tension in the banking system and provided that the liquidity proviso meant that the primary securities markets would continue to function in a reasonably adequate way.

Mr. Coldwell commented that in his opinion the developments of the past month still left unresolved the basic question of whether sufficient progress was being made toward economic stabilization. It seemed apparent that the rate of real economic growth had slowed but that the economy as a whole was still advancing and, in specific sectors, the rate of gain was clearly unsustainable. Moreover, prices and costs were moving up at an unacceptably rapid pace.

The System's efforts to restrain the economy had been blunted, Mr. Coldwell said, by the utilization of a large pool of liquidity and the steadily more rapid turnover of funds. Banks as individual institutions had found ways to avoid credit rationing while the banking system had been fed only a parsimonious quantity of new reserves. With great patience and forebearance the System might wait out the forthcoming collision between strong credit demands and limited new supplies. However, after six months of waiting while price increases accelerated and more of the general public became convinced of the inevitability of further inflation, he believed it was time to call a halt.

Mr. Coldwell thought that interest rate increases had gone so far that the impact of further advances on the credit demands of businessmen or consumers appeared negligible. The only thing that an avid borrower understood was a firm "No, we have no funds for new loans." Thus, availability of credit and attitudes of bankers were the keys to real restraint.

An additional increase in discount rates might have advantages in bringing them into better alignment with market rates and forcing a better relationship between the costs to banks of alternative means of adjustment, Mr. Coldwell continued. However, if bankers were not serious about making adjustments and merely wanted to sustain their overloaned positions, then a rate increase would just add to the fire of higher costs and might be a destabilizing influence. Moreover, there were clear political and institutional risks in such a move at this time. The System should be certain that there were clear advantages to a discount rate increase and that it was not just following the commercial bank prime rate move. If the yield differential was measured against the bill rate, the discount rate was not as far out of line now as in past situations. On balance, he did not favor a discount rate increase at the present time. Nor did he favor a change in Regulation Q ceilings. Those ceilings had acted as the cutting edge of policy recently, and he saw no reason for raising them now.

Mr. Coldwell's preference for handling the discount window under present conditions was a tighter administration uniformly applied throughout the nation. If the System was serious about containing inflation, he thought the banks that were still taking every opportunity to extend additional credit and were sustaining their positions by Federal funds purchases, Euro-dollar borrowings, or sales of assets should be counseled with individually and placed in a special category. Perhaps a Board statement to that effect would be helpful, as would be Board action to enlarge the penalty for reserve deficiencies.

As members of the Committee knew, Mr. Coldwell continued, he had been asking for further restraint and especially for a statement to the banks requesting special efforts to limit loan accommodation, particularly to businesses. He would reiterate that request today, and hoped that such a broad appeal could include the injunction to the very aggressive banks.

As for current monetary policy, Mr. Coldwell said he favored further restraint through open market operations and a directive that would instruct the Manager to keep conditions taut at all times and to seek opportunities to tighten money and credit relationships further. Such a policy would have the effect of offsetting to some extent the projected rundown of Treasury deposits and would keep bill yields at a higher level. Effective Federal funds rates should, in his opinion, be kept above 9 per cent.

With regard to regulatory changes to limit individual bank sales of loans, guarantees of commercial paper, issuance of paper by a holding company or affiliate, or other devices to evade

Regulations D and Q, Mr. Coldwell said he approached such changes from a fundamental position that banks should operate within their own resources. With that premise and the basic assumption that such devices were being used by only a limited number of banks, he would favor some Board curtailment of those devices. However, he was more concerned with the over-all limitation of reserves.

On the Euro-dollar reserve proposal, Mr. Coldwell indicated he was in favor of extending reserve requirements on all new borrowing as of a specific date but without retroactivity. He was concerned about the balance of payments impact of forcing retrenchment in such borrowing, but he was more concerned about the further build-up in the overhang of borrowings and its impact on the world-wide interest rate competition now under way.

With respect to the draft directive, Mr. Coldwell suggested deletion from the first paragraph of the statement that the nonbank thrift industry "reportedly was preparing for sizable outflows during the mid-year interest-crediting period." He saw no reason to include only one phase of the projection, especially one which involved considerable uncertainties. In his view the second paragraph of the draft directive was unacceptable. He suggested that it be reworded to state that ". . . operations . . . shall be conducted with a view to developing firmer conditions in money and short-term credit markets . . . ."

Mr. Swan said he thought monetary policy should remain unchanged at present, with open market operations directed at maintaining the current firm conditions in money and short-term credit markets. This certainly was not a time to ease or to give any kind of signal that might be interpreted as easing. But, like Mr. Morris, he felt just as strongly that policy should not be tightened further at this point. Having come through the period of peak pressures associated with the mid-June tax date, it seemed to him that the Committee should maintain a steady posture until it was in a better position to assess the degree to which those pressures were unwound. He thought it possible that there would be some lessening of inflationary expectations in the weeks ahead, although such a judgment admittedly was difficult to support.

Mr. Swan remarked that he would not favor increasing the discount rate at this point--even though it was well out of line with market rates--because an increase would have an undesirable announcement effect. As he had indicated, he believed that any policy action likely to be interpreted as an overt move toward further tightening would be inappropriate now. He would prefer to watch interest rate developments for a time and to see whether or not the surtax was extended before making a decision about the discount rate.

Mr. Swan thought consideration should be given to measures restricting marginal increases in Euro-dollar borrowings and bank use of some of the other fund-raising devices that had been mentioned. He was concerned about one new device--the so-called placement of depositors' funds in the Federal funds market. Although the exact mechanics were not clear, the funds involved evidently were moved out of the deposit category and the Federal funds rate was paid on them. The San Francisco Reserve Bank did not have knowledge of any specific transactions of that type shown on the books of a bank but rumors of its use were becoming increasingly widespread. The device was of immediate concern because of the implications for required reserves of the transfer of funds from deposit to nondeposit categories. It also seemed to have serious longer-run implications, as a threat to the whole structure of demand and time deposits and to the Regulation Q ceilings on time deposits. It was the kind of development that could spread rapidly in response to competition, and in his judgment it required the immediate attention of the System.

Mr. Swan observed that he would not favor an increase in ceiling rates on large-denomination CD's at this point, although he recognized that banks were resorting to new fund-raising devices because of the restrictive effects of present ceiling rates. He shared the view that an increase in ceilings might be interpreted as a backing-off from monetary restraint. However, if an effective check on the escape valves could be developed promptly, some change in Regulation Q ceilings might be possible without any implications of easing. But consideration should first be given to closing the loopholes.

Mr. Swan said he could accept the directive as drafted by the staff. He thought the new language proposed for the second paragraph was much to be preferred to the wording of the previous directive. He had no objection to the addition of a reference to unusual liquidity pressures in the proviso clause, although it was not clear to him why the reference was proposed now; he thought a better case could have been made in connection with the previous directive, when the pressures associated with the mid-June tax date still lay ahead.

Mr. Galusha commented that the Board staff had given the Committee what was, in a way, an encouraging economic outlook. The Committee had been told that the GNP deflator was going to continue increasing, but--what was most important--at a decreasing rate. For a while at least, it would simply be a case of past increases in costs pushing prices higher. Apparently, prospects were for actual decreases in real GNP and, extending over the next few quarters, what he regarded as rather a sharp increase in the unemployment rate. But, of course, while not speaking of it, Committee members had known all along that such an increase was almost inevitable.

If the Board staff's forecast turned out to be correct, Mr. Galusha continued, by next summer there might be a few unpleasant things said about the Federal Reserve. With interest rates having increased to record levels, and with the various monetary aggregates having increased relatively little, there was not a chance that the System would escape blame for the minor recession which seemed to be in the offing. But that prospect should not dissuade the System from carrying on. The staff outlook could be wrong, although he personally did not think so. It seemed to him the System was close to having altered business expectations if, as Mr. Morris had indicated and as he believed, the stock market was the best thermometer for taking the temperature of inflationary psychology. But in order really to change expectations, he thought the System had to carry on a bit longer.

Accordingly, this morning he was for no change in Committee policy, Mr. Galusha continued. He was not joyous about prospects for further decreases in bank credit, but even modest changes in monetary targets could easily be misinterpreted.

Nor did Mr. Galusha think that discount rates should be increased. They were out of line with market rates, but a supposedly technical adjustment of any size would be misinterpreted and he saw little, if any, advantage to be gained by raising discount rates.

At this nervous juncture, Mr. Galusha observed, there was a risk that market participants would over-react, one way or the other, to whatever the System might do; and that being so, he would have it do nothing--other, that was, than to carry on as it had been. He would have the System leave discount rates unchanged and, unless absolutely necessary, refrain for the time being from issuing any new rules or regulations. If, as some had indicated, a move to control in some way the flow of Euro-dollars not only might help alleviate the System's current problem but might also mitigate some of its troubles when domestic interest rates started to unwind, he would certainly favor the exploration. For, unless the Committee chose to ignore today's extraordinarily good staff presentation as well as the lessons of history, it could anticipate rate easing and some attendant troubles next year.

In conclusion, Mr. Galusha said he could accept the targets for money and short-term credit market conditions spelled out in the blue book and the staff's draft of the directive. He particularly liked the proviso clause shown in the draft and would urge that it be adopted.

Mr. Scanlon said that in the interest of time he would summarize the statement he had prepared concerning developments in the Seventh District and would submit the full text for inclusion in the record. He then summarized the following statement:

We have no convincing evidence that pressures on resources in the Seventh District have eased.

Price increases on manufactured goods announced in the past few weeks have been far more numerous than at any other time in recent years. The increases have been relatively large, commonly 5 per cent or more, and have covered a wide variety of goods.

District wage increases granted this year show no tendency toward moderation. Newly negotiated contracts commonly call for increases in compensation ranging up to 10 per cent per year and more.

Advertising for workers has been stepped up in recent months, possibly in an effort to acquire some of the new crop of high school and college graduates. Unemployment compensation claims in the District are well below last year, except for Iowa.

Labor shortages are especially severe in the Chicago-Gary steel producing area. Major plants would like to hire large numbers of additional workers, including many unskilled workers. Partly because of extended vacations, steel firms will be hard put to catch up on deferred maintenance and repair work this summer while maintaining production at a high level. There are many reports of labor absenteeism, especially in the auto industry, that hamper production and, therefore, productivity.

Output of consumer durables, other than automobiles, appears to have leveled on balance in recent weeks, but demand for certain items, including furniture, mobile homes, refrigerators, air conditioners, and dehumidifiers, is very strong.

Auto producers with whom we talk are sticking to forecasts made earlier in the year that sales of passenger cars, including imports, will be close to 9.5 million units this year. Truck sales are generally expected to exceed 1.9 million units and perhaps to reach 2 million, for a new record.

The greatest strength continues to center in producers' equipment, including trucks, trailers, railroad equipment, industrial and commercial air conditioning, and machine tools. Farm machinery sales, weak earlier in the year, have improved recently. Orders for most types of equipment surged in April with demands for repeal of the tax credit. But the reaction in May and June has not been as great as had been expected.

Many capital expenditure projects are behind schedule because of delays in deliveries, labor shortages, or

> strikes, but we know of very few "voluntary" cut-backs on capital expenditure plans this year.
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> The national retail sales data are puzzling. They may be understating actual results--particularly for restaurants, service stations, furniture and appliances, drug stores and, possibly, food. If estimates of total sales and sales of the large chains and department stores are correct, the small and specialty retailers must be doing badly. We have seen or heard nothing indicating that that is occurring on a broad scale.
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> Business loans at weekly reporting banks in the District continue to increase despite the sales of loans by some banks to their overseas branches. The two largest Chicago banks are estimated to have sold in excess of $300 million of loans. Treasury securities continue to run off and there have been some sales of municipals.
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> Chicago banks continue to operate in a deep basic deficit position, borrowing heavily in the Federal funds and Euro-dollar markets. Their deficit has been close to its current level since March. Those banks have made only moderate use of the discount window.

Mr. Scanlon then said that money supply and bank credit appeared to be increasing less in June than had been projected. In light of current and projected business developments, that had been desirable. With evidence of moderation of the pace of inflation so slow in surfacing, it was perhaps surprising that interest rates had not risen even more strongly. Efforts to hold down interest rates now would be likely to thwart the Committee's major objective--namely, containing inflation.

It would appear, Mr. Scanlon continued, that more indications of easing of pressure on resources should be evident, given the slowing in real economic activity implied in the quarterly estimates of GNP. The fact that that was not the case raised a question as to whether a program of gradualism could overtake an inflation that had gained substantial momentum. Certainly, drastic actions in the fiscal and monetary sectors were much to be preferred to either further drift toward price and allocation controls or to decided steps in that direction. But it would be premature to abandon the gradualistic approach at this time.

However, Mr. Scanlon observed, within that basic approach he would favor some changes that would help to keep the markets functioning. First, in contrast to some others who had spoken today, he thought the discount rate should be moved closer to relevant market rates. The discount window would then be more effective as a safety valve since there would be less need to raise the spectre that the window might be closed altogether or against certain groups of borrowers. He thought there was one ill effect from the lack of a change in the discount rate. The large subsidy the Reserve Banks provided on member bank borrowings, which were now in excess of $1 billion, seemed quite inconsistent with the System's announced policy of restraint. He recognized that there was a problem of timing, but to delay an obvious action because it might interfere with the passage of tax legislation or because of announcement effects was an approach that had not proven successful in the past. If it was the right action to take, he would take it.

Secondly, Mr. Scanlon continued, he saw merit in establishing some reserve requirements against Euro-dollars and other fund-raising devices used by banks, although he was not certain how an effective method of doing so could be found. Perhaps there would be an opportunity to tie in such a measure with a third action: raising the ceiling on rates paid by banks on savings. The System's posture in holding down such rates was becoming increasingly incongruous in an inflationary setting and should be changed along the lines the Board was considering. Whether that could be done without marked political repercussions he did not know. But the evidence that funds quickly found alternative channels was becoming more and more impressive.

Mr. Scanlon thought an appropriate policy posture would be to provide for slow growth in total reserves, assuming Regulation Q ceilings were raised so as to end the run-off of CD's. Such a policy approach would be consistent with slow expansion in the money supply and bank credit. In terms of a money market directive, he favored maintaining about the prevailing degree of firmness in money and short-term credit markets. The staff draft of the directive was satisfactory.

Mr. Clay remarked that there was some evidence of moderation in the pace of economic activity. In view of the monetary and fiscal restraint that had been applied, however, the continued degree of expansion remained rather impressive. An important part of the projected further slowing reflected a marked reduction in the growth of business spending for fixed capital.

Of chief concern, Mr. Clay noted, was the continuing strong inflationary push of costs and prices. There was no need to catalog here the important reasons, in terms of both domestic and international considerations, why that trend had to be checked. The record to date was not encouraging.

Increasing evidence of strains was apparent in financial markets and institutions, Mr. Clay continued. One indication was the scramble for nondeposit sources of funds by commercial banks operating under the limitations of the Regulation Q ceilings. Much had been said about that with respect to the largest money center banks, and no doubt the greatest amount was to be found there. However, the data collection just initiated by the System had revealed more such efforts among the largest Tenth District banks than anticipated; each of the nondeposit sources specified was found to be employed by one or more of those banks. In addition, it was evident that plans were being made for the expansion of such methods of obtaining funds.

Mr. Clay said that in view of the lagged effects of public economic restraint measures, including the forthcoming fiscal legislation, it was difficult to know how much restraint was needed and how long any given degree of monetary restraint should be applied. While every effort had to be made to observe whatever evidence became available for making that judgment, it was going to be necessary to take some risk of overdoing and overstaying.

For the present, there appeared to Mr. Clay to be little choice except to continue the firm policy that the Committee had been pursuing. Extension of the surtax, along with enactment of the other fiscal restraint measures, was of the utmost importance.

Under the prevailing circumstances, Mr. Clay added, statistical guidelines for the Manager were difficult to formulate and probably should be stated in rather broad ranges. Given the uncertainties of the flows of funds and other factors, the guidelines for money and short-term credit market conditions listed in the blue book appeared to be reasonable approximations for the period ahead.

Since the Federal Reserve discount rate was seriously out of line with other money market rates, it should be increased at an early date, Mr. Clay said. He realized that the timing of such an increase was a problem and he was not at all certain what that timing should be.

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

Mr. Heflin commented that economic activity in the Fifth District apparently continued to expand, but the Richmond Bank's survey of business conditions indicated declining optimism among businessmen and bankers. As a matter of fact, the responses were the most pessimistic in many months. The survey also showed a marked turn away from the bullishness that had been experienced in the

District in retail trade and automobile sales. While total District construction activity was continuing to advance, residential construction had continued to slow. District lumbermen reported sharp reductions in prices and increased supplies, reflecting to some degree the softness developing in residential building.

Mr. Heflin observed that credit markets appeared to have adjusted reasonably well to the latest prime rate hike, although it seemed to him that a high degree of uncertainty continued to dominate market sentiment. The unusually large takings of Euro-dollars at interest rates as high as 13 per cent reflected the extent to which the banking system was feeling the policy pinch. In that kind of climate he was somewhat concerned over the latest blue book projections of the prospective behavior of the bank credit proxy. The adjusted projections would appear to imply a level of Euro-dollar borrowings that could add significantly to the pressures in foreign markets. Moreover, he was not altogether comfortable with the prospect that credit would continue to decline for another month and perhaps longer.

Nevertheless, Mr. Heflin said, given the seriousness of the inflation problem he would recommend against any relaxation of the current degree of restraint. He believed the System had achieved about the right policy posture and, while he would not want to overstay that posture, he was convinced that it had to be maintained for the present. On the other hand, given the present degree of stringency and the current expectational climate, he believed that any overt move toward further restraint at this time would involve unnecessary risks of financial disturbances both at home and abroad. For that reason he would not recommend any discount rate action at this time. The directive was satisfactory as drafted.

Mr. Mitchell said he could find no fault with the analysis the staff had presented today and he thought their conclusions regarding policy were appropriate to the situation. Like Mr. Scanlon, he disliked the subsidy implications of the present level of the discount rate, but he thought an increase now would have undesirable announcement effects. Hopefully, the System would find a better opportunity later to bring the discount rate into closer alignment with market rates.

Mr. Mitchell agreed that no change in policy was the best course at present. However one might measure the existing degree of restraint, it was considerable; and, particularly in light of the lags involved, he would not want to firm further at this time. Indeed, in his judgment there was more danger that restraint might be excessive or continue too long than that it might be insufficient.

Mr. Mitchell remarked that he disagreed with most of what had been said thus far about curtailing bank use of nondeposit funds. He thought it was appropriate to think of credit restraint as applying not to banks alone but to the whole economy. It seemed inconsistent to him to argue that it was desirable for banks to sell assets in the form of securities but undesirable for them to sell loan participations or commercial paper. In his judgment none of those transactions was undesirable since whatever banks sold had to be absorbed by the economy. For that reason he thought it was unnecessary to try to close most of the "loopholes" that had been mentioned.

However, Mr. Mitchell continued, he would make an exception in the case of Euro-dollar borrowings because of their consequences for foreign financial markets. If the flows had been in the reverse direction this country might well have expected other countries to take measures that would provide relief, and it was reasonable for them to expect the System to act now. Thus, he thought some action was required to reduce the inflow of Euro-dollars, although he was uncertain at the moment as to the appropriate form of the action.

Also, Mr. Mitchell said, he thought the Board should act at some point to raise the Regulation Q ceilings on large-denomination CD's of longer-term. His reservations about doing so at present were based solely on considerations of timing; it would be extremely unfortunate if such an action were taken now and interpreted as a relaxation of monetary restraint. Perhaps that risk could be avoided by combining the change in Regulation Q with an increase in reserve requirements.

Mr. Mitchell thought the staff's draft directive was appropriate. However, in light of the comments in the chart show today about the use of reserves for target purposes, he wondered why the staff had not proposed directive language involving reserves.

Mr. Daane said he had found the staff's analysis excellent and persuasive. Nevertheless, he still thought the Committee's immediate problem was inflation and inflationary psychology, and he was not convinced that the System had done all it could do in dealing with that problem. While he did not advocate any appreciable further tightening, he would favor shading open market operations in that direction. To use an old System expression, he would "err on the side of restraint" and perhaps go a bit further.

Mr. Daane remarked that he had mixed feelings on the question of whether the Board should restrict the various fund-raising devices banks had been using. Once the Board embarked on that course it would be faced immediately with the issue of Regulation Q ceilings on large-denomination CD's, and he would be reluctant to increase the ceilings at the moment for the reasons Mr. Treiber had mentioned. If the Board were to raise the Q ceilings, however, he thought it would be appropriate to accompany the action with an increase in the discount rate. While a discount rate increase at this point could be described accurately as a technical adjustment, it would also serve to remove any sense of easing that a change in Q ceilings alone might convey.

As to the directive, Mr. Daane said he would be agreeable to the language Mr. Coldwell had suggested for the second paragraph. However, if that language were not acceptable to a majority he would favor retaining the wording of the previous directive, calling for maintenance of prevailing pressure on the market, rather than employing the modified language proposed by the staff.

Mr. Maisel remarked that the Committee faced a series of questions in attempting to judge what existing monetary policy was. What would be the current and lagged impact of action already taken? What measures should the Committee use of the degree of restraint contained in current policy? What did it really mean by current firmness? What advantages and risks appeared likely if it adopted the proposed directive?

If the Committee looked back at the past quarter, Mr. Maisel said, it would note a steady escalation of firmness in money market conditions as well as a steady fall in the monetary aggregates. That tightening had occurred even though the directives adopted at the past two meetings had called for no change in policy. Now was the time to end that movement.

In the words of the Manager, Mr. Maisel continued, most interest rates had reached historical highs in the past four weeks. The average Federal funds rate in June would be more than 100 basis points higher than that of April and the peaks reached would be even greater. The three-month bill rate would be 40 basis points higher.

Borrowings and net borrowed reserves would have gone up. At the same time, the rate of growth in the bank credit proxy had decreased sharply, and even the narrowly defined money supply had been expanding considerably less rapidly.

Under the proposed directive, Mr. Maisel said, the Committee ran two types of risks. The first--and the one most within the Committee's control--was the likelihood that as liquidity continued to disappear from financial markets, the probability would increase that its rate of disappearance would accelerate and that that would lead to excess strains in particular financial sectors. The second and less likely possibility was that similar distortions would occur in output and production.

It seemed to Mr. Maisel that both of those possibilities had a high enough probability so that even if the Committee gave a low probability to the staff's projection--which he would not necessarily do--it ought to define current tightness in terms of the concepts it had considered advisable in January and February as to what a logical long-run monetary policy should be. It had agreed then to adopt a restraining, anti-inflationary policy, but one with moderate growth rates in the monetary and credit aggregates. Recent policy seemed to be driving the Committee beyond that point.

The problem was being escalated steadily, Mr. Maisel remarked. How could the Committee move most sensibly to a proper posture and path? How could it avoid a sharp stop-go shift? The longer it waited in getting back to a sustainable path, the more difficult the transition and the greater the likelihood that the transition would cause a major shift in expectations and credibility.

It appeared to Mr. Maisel that the Committee was at a point at which it should start to approach a maintainable policy. He did not think the present policy stance met that criterion. It was too likely to lead to a cumulative contraction of credit. The money market conditions that had been allowed to develop had led to contractions in the monetary aggregates even with extremely heavy demand for credit in the economy; any decrease in demand with current policy should mean that the contraction in credit would accelerate. The projections for July were for very heavy run-offs in both bank credit and total reserves.

In order to bring about the proper transition to a maintainable level, Mr. Maisel suggested that the second paragraph of the proposed directive be amended to call for operations to be conducted with a view to "maintaining the firm conditions prevailing during this quarter in money and short-term credit markets." That would mean net borrowed reserves slightly under $1 billion, the Federal funds rate below 8-1/2 per cent, and the three-month bill rate between 6 and 6-1/2 per cent. That would maintain recent average relationships while avoiding cumulative pressures arising as liquidity disappeared.

Another method of achieving the same goal would be through the use of the proviso clause, Mr. Maisel said. The Committee could adopt the proposed directive if it agreed that the proviso would go into effect and stay in effect if projections showed a negative number for the credit proxy including Euro-dollars.

Mr. Maisel believed that the directive proposed was really one for a further tightening of policy, as had resulted from the past two directives. As he had indicated, money market rates were higher and aggregate flows lower. He would not want to support a directive that projected a two-month--June and July--annual rate of decrease in the credit proxy of minus 10 to 12 per cent and an even sharper decrease in total reserves.

Mr. Brimmer commented that he saw no reason to change policy at this time. He found the staff's draft directive satisfactory, except that he agreed that the reference to the thrift industry's expectations of sizable mid-year outflows should be deleted from the first paragraph. That was a most unusual statement for the directive and was not needed.

Mr. Brimmer said he definitely would favor taking some steps to restrict fund-raising by banks outside the scope of Regulations D and Q. He favored dealing with Euro-dollar borrowings in the manner the staff recently had suggested to the Board.

Mr. Brimmer hoped the Board would be extremely cautious in approaching the question of a possible increase in Regulation Q ceilings. Apart from the fact that the ceilings had served as the cutting edge of policy recently, it was necessary to anticipate that banks would respond very quickly to any leeway allowed them by an increase in ceilings. That had been the experience following the ceiling increases in 1966 and 1968; on both occasions banks had recouped 90 per cent of their previous run-offs of CD's within two or three months of the Board's action. Recently banks had cut back substantially their new commitments for term loans but were continuing to make commitments on other loans at a rapid rate. If they were able to attract a substantial volume of time deposits as a result of an increase in the ceilings he would expect them promptly to increase the rate at which they were making commitments. He favored no change in the Q ceilings at this time.

Mr. Brimmer remarked that he was intrigued by the staff's suggestion that the Committee should now begin to give greater weight to aggregative targets, particularly reserves. He recalled that on various occasions the Manager had indicated that he would find it somewhat more difficult to operate under targets formulated in terms of aggregates than he did with money market targets. Before the Committee agreed to downgrade money market conditions for target purposes it would be desirable to have a statement from the Manager on the implications of such a change for his operations.

Mr. Brimmer observed that he had found the staff's balance of payments projections interesting, but he noted that not much had been said regarding the near-term outlook. He thought the Committee should be aware of the fact that no plans were being formulated within the Government to cope with the payments situation. Indeed, efforts were being made to obtain some further relaxation of the control programs, particularly the foreign credit restraint program. He saw no reason for any optimism in that area.

In concluding, Mr. Brimmer said he thought today's chart show merited the favorable comments that had been made. In addition, explicit note should be taken of the hard work done by the staffs of both the Board and the New York Reserve Bank in connection with possible regulatory action to close the Regulation D and Q loopholes.

Mr. Sherrill said he approved the staff's draft directive as written except that he also would favor deleting the reference to possible mid-year outflows at thrift institutions. He thought that the current firm stance of monetary policy was correct, and that it should be maintained at present without any suggestion of easing. He firmly believed that the Board should not raise Regulation Q ceilings at this stage because such an action would be interpreted as a significant lessening of the degree of monetary restraint. He did not think an increase in the discount rate was necessary now in light of the fairly stable situation at the discount windows, but he would want to consider such action later, perhaps in July.

Mr. Sherrill remarked that Euro-dollar borrowings by U.S. banks had become so large as to involve considerable risks, both domestically and abroad. Accordingly, he would favor Board action to restrict the inflow. He thought the System also should move promptly to stop Federal funds transactions of the type Mr. Swan had mentioned, if his understanding was correct that those transactions were a device for paying the Federal funds rate on depositors' funds.

As to other nondeposit sources of bank funds, Mr. Sherrill favored preparing now to take action later to the extent that might be considered necessary, but not acting at this time. Bank access to funds from such sources would be useful as a safety valve for the time being, particularly if action were taken in the Euro-dollar area.

Mr. Hickman observed that the economic situation had not changed substantially since the Committee's last meeting. The real rate of economic growth remained below the potential rate at which the economy was capable of expanding. As the Board's staff had indicated in the green book,[1/] the rate of gain in real GNP probably again fell below a 3 per cent seasonally adjusted annual rate this quarter, with further softening expected in the third and fourth quarters. Nevertheless, it was clear that neither price pressures nor expectations of continued inflation had yet been brought under control.

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

The recent sharp increase in interest rates in all sectors was a matter of deep concern in the Fourth District, Mr. Hickman said. The immediate cause of the latest surge in interest rates was the increase in the prime rate, but the stage had been set by extreme pressures in financial markets, which were reminiscent of the credit crunch of 1966. With the passing of the tax and dividend period, market pressures seemed to have eased a bit. The question now was whether the slightly improved tone would be allowed to continue, or whether market pressures would build up again to the levels of early June.

Mr. Hickman thought a restrictive monetary policy was appropriate under present conditions. There was, however, some question as to how restrictive policy should be. The System's staying power might ultimately prove to have been weakened by the extreme pressures that had been allowed to develop since the Committee's last meeting. What was needed, in his opinion, was a moderately restrictive policy that could be maintained over a period long enough to eliminate inflationary expectations. If monetary policy swung too far toward restraint--as he thought it might already have done--it might induce an actual decline in real output before inflationary expectations were brought under control. If that occurred, the question would then be whether the Committee would be willing to maintain an appropriately restrictive policy, or whether it would swing to the side of ease, as it had in 1967 and again in the last half of 1968. In his opinion, the Committee should adjust its sights to reasonable targets that could be maintained over an indefinite period. After five or six months of virtually no growth, or outright declines, in the reserve aggregates and the bank credit proxy, it was time for a modest first step toward the establishment of monetary conditions that would accommodate moderate long-run credit growth. He thought that continuation of the current severely restrictive monetary policy would be dangerous, and, therefore, he would not favor the staff's draft directive. He would, however, find acceptable a directive of the kind suggested by Mr. Maisel.

For political, economic, and psychological reasons, Mr. Hickman said, he would prefer to leave the discount rate where it was, at least until the passage of the surtax was assured. He would, however, recommend to the Cleveland Bank directors that they move with the System in the event the Board of Governors thought a change was appropriate. If that occurred, he would recommend that the increase be coupled with a modest upward change in the ceilings on large-denomination CD's. He was afraid it might be a little late in the cycle to do very much about reserves on Euro-dollars, although he thought something should have been done earlier in that area.

Mr. Bopp commented that for some time the money and credit aggregates and money market conditions had been registering clearly the restrictive monetary policy instituted at the beginning of this year. Most recently, revisions in the money and credit aggregates for May and projections for June indicated that, if anything, policy might have been a bit more restrictive than the Committee had intended.

In a recent survey of large Philadelphia banks, Mr. Bopp said, it was found that their experiences over the quarterly tax-payment date were about what they had expected. Last minute bulges in loan demand and deposit declines did occur but were met with a minimum of discomfort largely because they were well within the ranges projected and prepared for by the banks. However, all of the reporting banks were feeling the bite of the pressure accumulating since the beginning of the year. As a result, within the past few weeks several of the banks had initiated even more strict credit rationing.

In spite of the impact of policy on financial variables, Mr. Bopp remarked, the response of the real sector of the economy was still disappointingly little. The spurt in the index of industrial production during May was particularly disappointing since its behavior in the past few months had been one of the few indicators of developing moderation. In view of the upward revision in plant and equipment expenditures for the second quarter and the economy's general posture of strength, the $16 billion increase in GNP recorded in the first quarter now seemed likely to be approximated in the current quarter. The impact of policy on prices seemed to be even further down the road.

Locally, Mr. Bopp continued, the Philadelphia Reserve Bank's May survey of the business outlook indicated that the number of manufacturers expecting increased business six months hence had dropped sharply for the first time since the end of last year. While the June survey confirmed that shift in expectations, no further declines had occurred. Businessmen still expected prices to continue to rise.

The tax-payment date and the problems it posed for policy were now past, Mr. Bopp observed. Nevertheless, the policy choice this morning was as difficult for him as four weeks ago. On the one hand, the requisite degree of moderation in the economy was not yet in sight. On the other hand, still confronting the Committee were the questions of how much more resilience the financial system could possess and whether it would be possible to avoid a credit crunch. On balance, he concluded that the costs of faltering in the effort to gain control of aggregate demand were so high that there should be no relaxation of the restraint that had prevailed thus far this year.

Mr. Bopp reported that at its last meeting the Philadelphia Reserve Bank board of directors had debated at some length whether to raise the discount rate. Although they went along with his recommendation of no change, they had strong feelings that monetary policy should be tighter than it was. Several directors had indicated that they would like to see increases in reserve requirements and imposition of reserve requirements against Euro-dollar deposits, as well as regulation of other sources of bank funds.

In his judgment, Mr. Bopp said, the Committee should not tighten the money and short-term capital markets further. The discount rate, of course, was far out of line. There had been no administrative difficulties for the discount window in the Third District and its share of total national borrowings had been small. He would, however, be willing to go along with some discount rate adjustment if other Districts had had administrative problems that might be mitigated by an increase. He had some difficulty in deciding when such an increase would best be made.

Mr. Bopp thought the staff's draft of the directive was appropriate except that he would favor deletion in the first paragraph of the reference to expected outflows around mid-year at nonbank thrift institutions.

Mr. Kimbrel said that, judging by the performance of Sixth District banks, System policy was not achieving the desired reduction in loan growth. District banks continued to mount a greater loan expansion than nationally. During May, in contrast to April, most of the loan growth had occurred at banks in the under-$100 million deposit group. However, at the large banks business loans continued to expand in early June.

One reason for the more expansive District-than-national loan performance, Mr. Kimbrel continued, might be the better-than-national deposit trends. Total deposits at all District banks combined had generally trended upward since the first of the year, largely because of time deposits other than savings at country banks. Moreover, the District's large reserve city banks as a group had not experienced the kind of attrition in deposits shown by the national figures.

Nevertheless, Mr. Kimbrel remarked, liquidity pressures were increasing and, at a few of the large banks in reserve cities, they had become intense. The reaction of such banks, however, had rarely consisted of cutting back on loans. Instead, there had been slight reductions in investments by some banks, greater use of Federal funds, limited use of the Euro-dollar market, increased use of nondeposit sources of funds, and borrowing from the Federal Reserve Bank.

District banks had deepened their basic reserve deficit rather considerably in recent weeks, Mr. Kimbrel reported. Federal funds purchases had averaged $600 million daily, compared with $500 million in early May, with the big banks in one of the reserve cities accounting for one-third of the total. Federal funds sales had shown a tendency to decline.

The banks that had been making intensive use of Federal funds, Mr. Kimbrel said, were apparently the ones that had exerted efforts to secure funds from nondeposit sources. The recent survey made at the request of the Board of Governors showed that nondeposit sources of funds at the thirty-two weekly reporting banks amounted to only seven-tenths of 1 per cent of total deposits for all of the banks reporting. However, at one of the banks nondeposit sources constituted 9.5 per cent of total deposits. Two of the District banks showed outstanding balances in Euro-dollars. One of the same banks accounted for most of the $35 million of commercial paper issued by a bank holding company reported by District banks. Again, one of those reserve city banks accounted for most of the consumer instalment loans sold. Those banks also had high loans-to-deposits ratios.

A careful bank-by-bank review suggested to Mr. Kimbrel that in the Atlanta District a relatively limited number of aggressive banks accounted for the major part of the loan growth. Those were also the banks whose efforts to maintain liquidity contributed to bidding up Federal funds and related rates. Although he was not familiar with the details of what was happening in other Districts, he gathered that somewhat the same situation prevailed elsewhere.

If that was the case, it seemed to Mr. Kimbrel that raising the discount rate even by a full point would have very little additional restrictive effect that was not already being exerted by the high cost of Federal funds, Euro-dollars, and any other sources those banks might be able to tap. Even those aggressive banks were apparently beginning to realize that they could not continue indefinitely to maintain their reserve positions with high-cost borrowed money.

That bankers were finally realizing they were going to have to do something about bringing their operations within their resources was evidenced by the visits to the Atlanta Bank last week of representatives of several of the District's large banks, Mr. Kimbrel remarked. It was interesting to him that, with one exception, the bankers' visits were at their own volition and not at the Bank's invitation. Moreover, most of them had emphasized that they were not coming to prepare the way for future borrowing. What they apparently were looking for was a receptive ear for a recital of their difficulties. Undoubtedly, they hoped they would learn that the Federal Reserve was going to take some action to rescue them. At least three of them suggested that some kind of controls would be appropriate. They did not like the idea of controls but apparently were looking for a crutch that would reinforce the actions they knew they had to take in reducing their loan expansion.

If the System could continue to limit general reserve availability and keep a firm administration at the discount window, Mr. Kimbrel observed, it should not be too long before it could expect to see even the aggressive banks exert a little more restraint in their lending.

Mr. Kimbrel said he personally believed there was considerable merit in closing the loopholes which had distorted the impact of monetary policy in its move to restraint. Nevertheless, with the delicate handling necessary to avoid contributing further to the nervousness at home and abroad, timing was important. He would not urge any change in Regulation Q ceilings on large-denomination CD's at this time, although such a move might be appropriate in the not too distant future if associated with an increase in reserve requirements.

Under those circumstances, Mr. Kimbrel remarked, he would like to have the System maintain about its present posture. He was, therefore, not in favor of a more restrictive policy. He was inclined to believe that raising the discount rate at this time would serve no useful purpose. On the other hand, raising the rate now would have several disadvantages, including giving the impression that the System was shifting toward a more restrictive policy and unsettling the money and capital markets further.

Under those conditions, Mr. Kimbrel indicated his preference would be to accept the directive as drafted by the staff after eliminating the reference to expected outflows at thrift institutions from the first paragraph.

Mr. Francis commented that recent monetary actions seemed to have been about right. Since the Committee had adopted a more restrictive policy in December, money had risen at a 3 per cent annual rate, or about half its average pace of the two previous years. The demand deposit component had increased even more slowly since December. Effects of those actions on total spending should be evident in the near future. Meanwhile, the System should not be swayed into adoption of credit controls in the hope that inflation could be slowed more quickly in that way.

Although monetary developments had been less expansionary since December, Mr. Francis said, they did not appear too tight, and the Committee should make certain that it did not relax either intentionally or unintentionally. Rather, it might be desirable to reduce the rate of growth of relevant monetary aggregates somewhat more, holding the growth of money to, say, a 2 per cent annual rate. Money had not grown at all for nine months from the spring of 1966 to early 1967, and the moderation in spending in early 1967, although pronounced, did not appear to him to have been excessive.

Mr. Francis noted that growth in some other monetary aggregates, such as money plus time deposits and total bank credit, had slowed more than money since last December. The studies of the St. Louis Reserve Bank and its interpretation of the Board's flow of funds information indicated, however, that those measures were likely to be misleading at this time since they reflected a switching of funds out of banks and into other markets rather than a net decline in total credit flows. That was due, of course, to the well-known impact of Regulation Q. Markets would be more efficient, small savers and small borrowers would be benefited, and bank credit and M_2 would be better measures of monetary developments if Regulation Q ceilings were raised or eliminated. If that was impossible, at least the Committee should not be misled into believing that the low rates of growth in those aggregates indicated that the System was being overly restrictive. It seemed to him that a relaxation of Regulation Q ceilings, at least on large-denomination CD's, would eliminate the need to consider further restrictive measures--of the type suggested by Mr. Treiber and others--to curb bank access to nondeposit funds.

Mr. Francis observed that the Committee had now had some time to evaluate the effects of the lagged reserve requirements which were implemented last fall. The chief advantage of the change that had been advanced was to make member banks more efficient in the utilization of their reserves. That advantage seemed to him to be of minor value compared with the adverse effects of the new arrangement. The System could provide more reserves at little or no social cost if the banks desired to hold greater excess balances. The System's ability to control monetary aggregates had been reduced. Since those effects were of importance to the System in its execution of policy, he suggested that consideration be given to rescinding the lagged reserve feature.

As for the immediate future, Mr. Francis trusted that the Committee would not relax the monetary conditions which had been attained. If anything, the growth rates of bank reserves, the monetary base, and money should be reduced a little further. In view of the high level of market rates relative to the discount rate, he believed it would be desirable to raise the discount rate by at least one percentage point.

Mr. Robertson said his statement today would be quite brief. For the first time in a long time, he thought System policy was on exactly the right track and that all that was needed was to hold steady.

Chairman Martin indicated that he concurred in Mr. Robertson's statement. As to the directive, a number of members had spoken in favor of eliminating from the first paragraph of the staff's draft the reference to expected outflows from nonbank thrift institutions at mid-year. The change in the second paragraph proposed by Mr. Maisel had not received much support in the discussion.

Mr. Robertson recalled that Mr. Treiber had suggested that the language in the second paragraph of the directive adopted at the last meeting, relating to the maintenance of "prevailing pressures," be retained in the new directive.

Mr. Daane said he thought Mr. Treiber's proposal would have some support.

Chairman Martin expressed the view that the choice between the second-paragraph language of the staff's draft and that proposed by Mr. Treiber was a matter of taste rather than of substance. In any case, the majority of Committee members seemed to favor the former. Accordingly, he proposed that the Committee vote on a directive consisting of the staff's draft with the reference he had mentioned deleted from the first paragraph.

With Mr. Maisel dissenting, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting suggests that expansion in real economic activity is continuing to moderate slightly, but that substantial upward pressures on prices and costs are persisting. Most market interest rates have risen considerably on balance in recent weeks, as credit demands continued strong against the background of considerable restraint on the banking system. Growth in bank credit and the money supply thus far in 1969 has been limited, and both declined somewhat on average in May. Large-denomination CD's have continued to run off at a rapid pace recently, and net inflows of consumer-type time and savings deposits have remained small. At nonbank thrift institutions, savings inflows slowed somewhat on average in April and May. Very heavy Euro-dollar borrowing by U.S. banks through their foreign branches produced a large surplus in the balance of payments on the official settlements basis after mid-May. On the other hand, high Euro-dollar interest rates apparently also stimulated outflows of

> funds from the United States that contributed to a large deficit on the liquidity basis thus far in June. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.
>
> To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the firm conditions currently prevailing in money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.

Chairman Martin then proposed that the Committee continue its discussion of possible outright System transactions in Federal agency issues. He noted that in accordance with the discussion at the preceding meeting the Manager had prepared two memoranda, suggesting guidelines for experimental operations and listing considerations against proceeding with outright operations at this time.1/

The Treasury had not yet reached a firm position on the question of System operations, the Chairman continued, although it was his impression that they thought it might be wise to delay

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1/ The first of these memoranda was entitled "Experimental open market operations in Federal Agency issues" and dated June 18, 1969; the second was entitled "Considerations against Federal Reserve operations in Agency issues at this time" and dated June 20, 1969. Copies of both memoranda have been placed in the Committee's files.

such operations until there had been more time to work toward consolidation of agency issues. If that course were followed, however, it was likely that no System action would have been taken by the time the Board was called upon to testify on the extension of the legislation authorizing the operations in question.

Mr. Robertson said he agreed that it would have been better if the Treasury had been able to accomplish some consolidation of agency issues before the System began outright operations. Nevertheless, it seemed to him that there was much to be gained by moving now on outright operations, and a lot to be lost by delaying. In particular, if the Committee had not acted by the time of the Congressional hearings to which the Chairman had referred, the System was likely to get a directive from Congress in the matter. He thought the guidelines suggested by the Manager in his memorandum of June 18 were excellent. If those guidelines were approved by the Committee and then made public through a statement to the press, misunderstandings of the Committee's intentions would be avoided, and in his judgment most of the arguments listed in the second memorandum against acting now would be obviated.

Mr. Daane said he thought both of the Manager's memoranda were excellent and the case made in the second memorandum against proceeding with outright operations at this time was a persuasive one. While he recognized that judgments could differ, it was his judgment that the considerations against moving now which Mr. Holmes had listed would be valid even if the guidelines were published. For example, he thought that by acting now the System would weaken its ability to avoid supporting individual sectors of the market, and he agreed with the Manager that once operations were launched it would be extremely difficult for the System to draw back in the event that the experiment proved unsuccessful. In sum, he believed it would be highly unwise for the Committee to undertake outright operations in agency issues at present.

Mr. Treiber concurred in Mr. Daane's observations.

Mr. Brimmer said he agreed with Mr. Robertson that the Committee should act affirmatively on the matter at this time and also that a press release containing the guidelines should be issued. Those steps, he thought, would strengthen the Board's position in the forthcoming Congressional hearings. Beyond that, publication of the guidelines should prove helpful to the Treasury in its efforts to rationalize the market for agency issues. He personally had no fears about being stampeded into undesirable operations so long as the System had the option to sell as well as to buy agency issues. The danger in not acting was that Congress would give the System a directive under which its options would be severely restricted.

Mr. Brimmer added that in his judgment the present situation was similar to that in 1966, when the Board had indicated to Congress that it was agreeable to legislation providing flexible authority to regulate maximum interest rates on time deposits--and by so doing had avoided a Congressional directive on rate ceilings. As on that occassion, it would be wise now for the System to take a modest and judicious step to avoid a more drastic outcome.

Chairman Martin remarked that Mr. Brimmer's comment about the 1966 experience posed the question clearly. In his opinion one could make a good case that the course the System had followed in 1966 had proved to be quite unwise; that the resulting heavy reliance on Regulation Q ceilings for monetary policy purposes had been the source of much of the difficulty the System now faced. He agree, however, that the two situations were similar in the sense that the issues involved in both were primarily political rather than economic. One could argue that it would be better to get a Congressional directive on System operations in agency issues, on the grounds that that would lead to a demonstration of their ineffectiveness in accomplishing the intended objectives, and thus to cancellation of the directive.

To his mind, the Chairman continued, the question of the appropriate course was an open one. If by adopting the guidelines suggested by the Manager the Federal Reserve could avoid getting too deeply into operations in agency issues, it might be best to go ahead on that basis. But even if the System undertook experimental operations under the proposed guidelines it might get a directive from Congress on the matter. In any case, he personally was convinced that the System would find it difficult to sell agency issues from its portfolio, so that its operations would be limited mainly to purchases.

Mr. Coldwell remarked that if the Committee approved the proposed guidelines the press release on the subject should indicate clearly that any purchases of agency issues would substitute for purchases of Treasury securities, and would not constitute net additions to the System's portfolio.

Mr. Francis observed that he would rather risk getting a Congressional directive than undertake experimental operations. If a directive were issued it would be apparent to everyone that Congress was responsible for the operations.

Chairman Martin said he was somewhat influenced by the fact that Treasury officials had not reached any firm conclusions on the matter, so that Treasury views could not be cited when Federal Reserve testimony was taken on extension of the legislation in question. At the same time, it was not clear to him that the hearings would be held before the next meeting of the Committee.

Mr. Mitchell commented that while he did not feel strongly he thought it would be wise for the Committee to take some steps which could be reported to Congress in the forthcoming hearings. However, he would not necessarily favor actually launching operations before that time. The Manager's June 18 memorandum implied that in any case some time would elapse before operations would be undertaken.

Mr. Holmes remarked that, as his memorandum indicated, before operations were actually started it would be desirable to hold discussions with the Federal agencies affected and with dealers to explain the principles embodied in the guidelines.

Mr. Daane asked whether it would be possible to hold such discussions without committing the System to actual operations.

Mr. Holmes replied that it might be feasible to talk with officials of the Federal agencies about the nature of possible System operations, while indicating that no decision to undertake those operations had been made. He did not think it would be wise to hold similar discussions with dealers in advance of a Committee decision.

Mr. Brimmer remarked that in his judgment it would be most unwise for the Manager to discuss the question with the Federal agencies involved until after the Committee had taken affirmative action and had made the guidelines public. It was unlikely that the substance of such conversations would remain confidential for long. In any case, one of the advantages of moving at this juncture was to improve the System's position in the forthcoming hearings, and for that purpose it would be desirable to announce the decision in advance of the hearings.

Chairman Martin said he found it quite difficult to judge whether affirmative action on the matter would strengthen or weaken the System's position. Perhaps it would be helpful to indicate that the System was willing to experiment with outright operations; but perhaps, as he had suggested earlier, Congress would issue a directive anyway. But while he was unsure on that point, he was sure that outright operations in agency issues, if carried too far, would constitute a trap for the System, at least if there was not a considerable degree of consolidation of such issues.

The Chairman then suggested that the Committee vote on the question of whether to amend the continuing authority directive, in the manner suggested in Mr. Holmes' memorandum of June 18, to authorize System operations in agency issues, subject to the guidelines also suggested in that memorandum.

Mr. Mitchell remarked that he was not prepared to vote favorably on a final action at this time. He would have no hesitancy about authorizing the Manager to discuss the proposed guidelines with the agencies, but he would like to reserve a final judgment on System operations.

Chairman Martin said the fact that the Treasury had not yet reached a firm position on the matter offered grounds for postponing a final decision until the next meeting of the Committee. For the System to act in the absence of knowledge of the Treasury's position would be a questionable procedure, in his opinion. On the other hand, the probable imminence of Congressional hearings on the underlying legislation argued against a delay. He understood that Mr. Cardon thought it quite likely that those hearings would be held before the Committee's next meeting, although that was not certain.

All things considered, the Chairman said, he personally would be prepared to take the risks involved in carrying the matter over until the next meeting.

Mr. Daane remarked that if Chairman Martin were prepared to take those risks he would support the Chairman's position.

Mr. Robertson said he thought it would be desirable for the Committee to vote up or down the question the Chairman had put earlier, and Mr. Brimmer agreed.

Mr. Sherrill suggested that the Committee might first be polled on the proposal that a decision be postponed until the next meeting, and the Chairman concurred.

The poll indicated that nine members favored that proposal and three (Messrs. Brimmer, Maisel, and Robertson) did not.

Accordingly, it was agreed that a decision with respect to outright System operations in agency issues should be postponed until the next meeting of the Committee.

It was agreed that the next meeting of the Committee would be held on Tuesday, July 15, 1969, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

June 23, 1969

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 24, 1969

The information reviewed at this meeting suggests that expansion in real economic activity is continuing to moderate slightly, but that substantial upward pressures on prices and costs are persisting. Most market interest rates have risen considerably on balance in recent weeks, as credit demands continued strong against the background of considerable restraint on the banking system. Growth in bank credit and the money supply thus far in 1969 has been limited, and both declined somewhat on average in May. Large-denomination CD's have continued to run off at a rapid pace recently, and net inflows of consumer-type time and savings deposits have remained small. At nonbank thrift institutions, savings inflows slowed somewhat on average in April and May and the industry reportedly was preparing for sizable outflows during the mid-year interest-crediting period. Very heavy Euro-dollar borrowing by U.S. banks through their foreign branches produced a large surplus in the balance of payments on the official settlements basis after mid-May. On the other hand, high Euro-dollar interest rates apparently also stimulated outflows of funds from the United States that contributed to a large deficit on the liquidity basis thus far in June. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

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