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, August 12, 1969, at 9:30 a.m.

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

Messrs. Francis, Heflin, and Hickman, 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
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Gramley, Green, Hersey, Link, Reynolds, Solomon, and Tow, Associate Economists
Mr. Coombs, Special Manager, System Open Market Account

Mr. Cardon, Assistant to the Board of Governors

Messrs. Coyne and Nichols, Special Assistants to the Board of Governors

Messrs. Keir and Wernick, Associate Advisers, Division of Research and Statistics, Board of Governors

Mr. Weiner, Assistant Adviser, Division of Research and Statistics, Board of Governors

Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors

Mr. Baker, Economist, Government Finance Section, Division of Research and Statistics, Board of Governors

Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Mr. Fossum, First Vice President, Federal Reserve Bank of Atlanta

Messrs. Eisenmenger, Parthemos, Taylor, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, and San Francisco, respectively

Messrs. Sternlight and Hocter, Vice Presidents of the Federal Reserve Banks of New York and Cleveland, respectively

Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively

Messrs. Scheld and Jordan, Assistant Vice Presidents of the Federal Reserve Banks of Chicago and St. Louis, respectively

Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the

Federal Open Market Committee held on July 15, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on July 15, 1969, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period July 15 through August 6, 1969, and a supplemental report covering the period August 7 through 11, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the Treasury gold stock was unchanged again this week, and the Stabilization Fund's holdings of gold remained at the high level of roughly $775 million. In the gold market there had been some encouraging developments in the form of a number of bearish factors tending to depress the free market price. In 1968 South Africa had achieved a sizable balance of payments surplus and had been able to hold gold off the market, but South Africa's balance of payments had now moved into sizable deficit which might be further aggravated by the recent relaxation of the country's exchange controls. Furthermore, the agreement on activation of the Special Drawing Rights had put at least a temporary damper on speculative gold buying, and there had been some well-founded reports of dissension among the Swiss banks that had been acting as agents for the sale of South African gold. There also had been considerable rivalry with London dealers who were operating against the Swiss consortium. Finally, there had been recurrent rumors of possibly sizable sales of gold by the Russians before the end of the year. Those developments had helped to push the market price of gold down to slightly above the $41 level late last week, and yesterday the price had moved up only slightly despite the shock effect of the French devaluation. The depressed price of gold had exerted a most helpful calming influence on the international financial markets.

The exchange markets, Mr. Coombs continued, had been in the summer doldrums until last Friday morning (August 8), and he had been looking forward to further progress during August in securing repayments on the Federal Reserve swap credits to the European central banks. From a peak of $2.1 billion in credits to foreign central banks reached last May, repayments had reduced the total outstanding to only slightly more than $1 billion at the end of July. It had been his hope that by the end of August the total debt might have been reduced further to roughly $750 million. The French move, which he had regarded as unavoidable since last November, had disrupted expectations that nothing would happen until after the German elections. Now, the exchange markets might well be on the verge of a new round of speculation which would force certain foreign central banks into further heavy drawings on their swap lines with the System. Thanks to the repayments in June and July, there was ample room for such drawings under most swap lines.

Mr. Coombs said he believed that if the 11 per cent French devaluation had been accompanied by a reasonable revaluation of the German mark, say even 6 or 7 per cent, the two moves in conjunction would have done a great deal to clear the air and to encourage the view that a new and fairly solid floor had been put under the parity structure. But by being forced to act alone, the French authorities had gained little if any margin of safety; they would probably encounter still new wage demands from the trade unions in September which would exacerbate inflationary pressures in the French economy. He was afraid that for some time to come the French, like the British, would be facing a skeptical foreign exchange market.

Even more troublesome, Mr. Coombs continued, was the fact that the French devaluation had stirred up speculation against other vulnerable European currencies. Yesterday, the Belgians had lost $33 million in support of the Belgian franc and had drawn on the swap line to cover $25 million of that loss. Further losses were expected today. Sterling also came under pressure yesterday, with the rate declining from $2.3860 at the opening to a New York close of $2.3830. Reserve losses totaled $40 million. After showing strength early today, sterling had begun to slide again and its latest quotation was around $2.3825-30. The forward discount on sterling had widened from 2-1/2 per cent last Friday morning to 6 per cent this morning. Tomorrow, the British would be publishing trade figures for July and he had the impression that the new figures would do little to restore confidence.

The Italian lira had also been under considerable pressure, Mr. Coombs said, with Bank of Italy losses totaling $70 million yesterday. The Scandinavian currencies were likewise showing signs of strain. Fortunately, an initial burst of speculation in favor of the German mark had quickly faded and there had been no inflows of hot money into Switzerland. For some weeks to come, speculative flows of funds might not go beyond the relatively mild pressures exerted so far on sterling, the Belgian franc, the lira, and the Scandinavian currencies. However, the general atmosphere remained explosive and in his view it would take very little bad news to set off a speculative run. Moreover, as the time for the German elections and the International Monetary Fund and Bank meetings approached, there would be a mounting risk of buying pressure on the mark and selling pressure on the vulnerable currencies. Just as in the crises of November 1968 and May of this year, that speculative combination could produce some massive movements of funds with correspondingly heavy drawings on the swap lines. He saw no alternative to accommodating the foreign central banks on the expectation that sooner or later the parities needed to restore confidence would be worked out.

Mr. Coombs added that neither the Treasury nor the Federal Reserve had suffered any losses as a result of the French devaluation. All uncovered holdings of French francs had been sold prior to the devaluation.

> By unanimous vote, the System open market transactions in foreign currencies during the period July 15 through August 11, 1969, were approved, ratified, and confirmed.

Mr. Coombs reported that a swap drawing on the Federal Reserve by the Bank of England would mature on September 9, 1969. The drawing, in the amount of $100 million, would be reaching the end of its second three-month term on that date. He would recommend approval of the renewal if, as he thought was likely, such renewal was requested by the British.

> By unanimous vote, renewal for a further period of three months, if requested, of the swap drawing by the Bank of England maturing on September 9, 1969, was authorized.

Mr. Coombs also reported that two drawings by the Netherlands Bank, each for $41.1 million, would reach the end of their first three-month terms on September 12 and September 16, 1969, respectively. The Dutch authorities would probably want to renew both drawings and he would recommend approval of the renewals if requested by the Netherlands Bank. It was his understanding that the Dutch authorities did not intend to let the drawings run on for a lengthy period and if necessary they would pay them off through a sale of gold.

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

Mr. Coombs said there was one other matter concerning which he would like to get the Committee's views. He noted that in mid-1966 a credit arrangement called The First Group Arrangement was set up to provide financing for British reserve losses attributable to liquidation of sterling balances. Under that arrangement, a number of foreign central banks had put up $600 million while the Federal Reserve and the Treasury together had informally agreed to attribute to the same arrangement a proportionate share of their own credits to the British--in the ratio of about $1 for every $2 furnished by the foreign lenders. By the fall of 1967, the entire $600 million made available by the foreign central banks had been utilized while $310 million of Federal Reserve and Treasury credits had been informally attributed to that First Group Arrangement. In effect, the Federal Reserve and the Treasury had shared in the credit package without entering into any formal agreement with the British and without making a specific allocation between the System and the Treasury of the credit extended or indicating whether guaranteed sterling or swap drawings were involved. In short, a global view was taken of the U.S. credits to the British.

Last year, Mr. Coombs continued, the British and other central bank members of the First Group Arrangement had worked out a repayment schedule calling for eight equal quarterly instalments of $75 million beginning in mid-September of this year. An additional quarterly instalment of $38.8 million was to be payable to the Federal Reserve and the U.S. Treasury. That arrangement was worked out at a time when there was some hope that the U.K. balance of payments would improve sufficiently to enable the British to make the repayments. In view of the prospective pressures on sterling in coming months, however, the proposed repayment schedule was beginning to look more and more unrealistic. He assumed that the Committee would wish to avoid a situation in which the British, either directly or indirectly, might finance those scheduled repayments by drawing on the swap lines. His own suggestion would be for the Committee to explore the possibility of arranging a temporary deferment of the repayments due under the First Group Arrangement. It was his understanding that the U.S. Treasury would favor such an approach and he would not expect any opposition from the Bank of England or from the other parties to the arrangement. Obviously, any new agreement need not involve an unconditional deferment of repayments but might incorporate a more positive approach in the form of a stretch-out of the repayment schedule.

In response to questions by Mr. Galusha, Mr. Coombs observed that in negotiating repayment terms with the British, the System and the Treasury might call for repayments in any quarter that the British took in enough funds through the exchange markets to cover the quarterly instalments. There was a precedent for such an approach in the 1946 Treasury loan to the United Kingdom which had provided for repayments in December of each year. In accordance with the terms of that agreement, the British had applied for and had been granted deferments in a number of years. The deferred payments were added serially to the end of the original payment schedule and perhaps a similar procedure might be followed in the present instance.

In response to further questions by members of the Committee, Mr. Coombs said that the Federal Reserve and the Treasury had not formally participated in the First Group Arrangement, which was negotiated through the Bank for International Settlements, because the credit package was felt to be too restrictive in purpose and because it was deemed preferable to maintain a direct credit relationship with the British. In effect, the System and the Treasury had entered into a parallel, if informal, agreement with the British to provide, as he had noted, financial assistance in the ratio of about $1 for every $2 supplied by the other lenders. The informal understanding had not involved any extra burden on the United States since in practice pressures on sterling stemmed not only from the liquidation of sterling balances but also from a variety of other influences and the System and Treasury were committed to honoring their swap line agreements in any event.

Mr. Coombs added that no decision had ever been made as to how the $310 million credit assistance to the British should be apportioned between the System and the Treasury. In his opinion, it would seem equitable to divide the total equally between both agencies. Thus, of the $815 million presently drawn by the British on their swap line with the System, some $155 million might be viewed as attributable to this particular credit extension.

Mr. Daane inquired whether such an arrangement could raise any doubts as to the availability of the entire swap line to the British and Mr. Coombs replied in the negative.

Mr. Mitchell said he was concerned about preserving the integrity of the System's swap line and he wondered if Mr. Coombs was suggesting in effect that $155 million be earmarked as an indefinite swap line credit to the British.

Mr. Coombs replied that he did not have in mind an indefinite credit. He was suggesting that the $155 million might be construed as the System's share of the credit to the United Kingdom and that as a practical matter it be considered part of the U.K. swap line debt to the System. However, alternative attributions could be made. As the Committee knew, the Treasury had extended $350 million to the British under its swap line and both the System and the Treasury held guaranteed sterling. His own proposal would permit the System to utilize, say, one-half of the British repayments under the First Group Arrangement to reduce the U.K. swap debt to the System.

After further discussion, Chairman Martin proposed that Mr. Coombs prepare a memorandum on this subject for the Committee to study. He (Chairman Martin) said he thought the Committee members were in sympathy with Mr. Coombs' suggestion but he felt more information would be useful.

There was general agreement with the Chairman's proposal. It was also agreed that Mr. Coombs' memorandum should include an inventory of current System and Treasury credits to the British.

Chairman Martin then invited Mr. Daane to report on the July meeting of the Group of Ten Deputies in Paris.

Mr. Daane said he could be brief since the outcome of the meeting held on July 23-24 was already known. The starting position of the Europeans was to promote the activation of only

$2-1/2 billion of SDR's each year for a period of three years. After a good deal of hard negotiation, in which he felt Under Secretary of the Treasury Volcker had signally distinguished himself, agreement was reached on the activation of $3-1/2 billion in the first year and $3 billion in the two following years. The United States did not succeed in securing acceptance of its plan to activate $4 billion or so per year over a period of five years, but he (Mr. Daane) thought the outcome of the negotiation represented a clear success and set the stage for actual activation by the members of the International Monetary Fund.

Mr. Daane added that the necessary number of countries had now ratified the creation of SDR's and had deposited the appropriate instruments of participation with the Fund. The next important step would be for the Managing Director of the Fund to make an actual recommendation. That would require a review and decision by the time of the annual Bank and Fund meetings in late September.

Mr. Daane observed that alongside the discussion relating to SDR's, consideration had also been given to the matter of increasing IMF quotas. After a good deal of debate, a consensus was reached on the desirability of an increase of 30 per cent, plus or minus 3 percentage points. There was also a clear understanding that selective adjustments in the quotas of individual countries would be desirable in order to take account of changing economic and financial circumstances. No commitments were made on this latter matter by the

United States or the other countries, but France seemed an obvious candidate for a quota change.

In further comment on the G-10 meeting, which he also had attended, Mr. Solomon remarked that he shared Mr. Daane's view concerning the importance of the SDR agreement. If the full $9-1/2 billion was activated over the next three years, the amount would be equal to about one fourth of the gold holdings of the IMF members.

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 July 15 through August 6, 1969, and a supplemental report covering the period August 7 through 11, 1969. Copies of both reports have been placed in the files of the Committee.

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

> The financial markets have come through a period of considerable stress in the past several weeks, and on the whole have come through it well--demonstrating resiliency and an ability to function even in the face of great uncertainty. It would be too early to conclude that markets for equities or fixed income securities are poised for a great rally, but there does seem to be a spreading view that the worst of the bad news for the markets has been seen. A period of backing and filling is perhaps the most likely short-term prospect. The French franc devaluation and speculation on other possible international currency developments may inject a renewed element of uncertainty into domestic financial markets, but thus far at least domestic markets have taken the latest step fairly calmly.

As much as anything else, credit for the better atmosphere in recent weeks should go to the Congressional agreement on a continuation of the tax surcharge. While the extension for only six months falls short of the Administration's request, the agreement ends a period of political wrangling that threatened the possibility of truly chaotic conditions. Progress on tax reform proposals also helped the markets, for even though the final outcome is not known, there is at least a specific House-passed bill to focus on. Earlier, a succession of news reports as the legislators went about their work had seemed to open up vast new uncertainties in one area after another. The market for State and local government securities, which had been especially hard hit because of potential legislative inroads affecting the tax treatment of income on these issues, experienced considerable relief when it became known that the Ways and Means Committee bill would not impair the attractiveness of these issues to commercial banks, as had been feared earlier.

To some extent, a better feeling in the markets for fixed income securities seemed to reflect a view that the economy's real growth was gradually slowing, although there appeared to be little optimism about near-term prospects for slower price and wage increases. In the case of short-term money market instruments, there seemed to be some abatement of the pressures that had caused rates on commercial paper and acceptances to soar around midyear, and these rates receded in the recent period. Rates stayed high or even rose somewhat further on Federal agency paper, however, as increased supplies were pressed on the market.

Treasury bill rates moved diversely but in a fairly narrow range over the period. The three-month issue was sold at an average rate of 7.08 per cent in yesterday's auction compared with 7.10 per cent four weeks earlier and a peak of 7.22 per cent in the July 22 auction. Six-month bills sold at an average of 7.28 per cent yesterday--down from 7.40 per cent four weeks ago and below the 7.46 per cent auction peak on July 22.

The Treasury refunding operation, in which holders of $3-1/2 billion of 6 per cent notes maturing August 15 were given an opportunity to exchange into 7-3/4 per cent eighteen-month notes priced to yield 7.82 per cent, proceeded smoothly and successfully. The fact that the Treasury chose to deal only with the August maturity on this occasion, leaving the $6 billion October 1 maturity to be handled later, appeared to be another constructive influence on the capital markets--the Treasury's decision relieved the markets for the time being from the need to handle a larger and probably longer-term new issue and perhaps conveyed to some market participants an impression that the Treasury thought it could refinance at lower rates later. The new eighteen-month notes were considered quite attractive and quickly moved to a premium which at one point reached as high as 9/32 over the offering price. Despite the high premium, not very many rights came into the market and dealers built their own net position in the new notes to a moderate level just under $400 million--probably somewhat less than they might have taken if rights had been more readily available. In part, the light flow of rights into the market represented sheer inertia as nearly 14 per cent of the privately held rights were not exchanged--a somewhat larger proportion than the market had anticipated in light of the substantial premium.

Open market operations during the recent period were designed to maintain firm conditions, while making allowance for the behavior of bank credit indicators, for the Treasury financing, and for the climate of market opinion as many participants seemed to be watching for signs of change in underlying credit conditions. The performance of bank deposit measures was such that even after allowing for Euro-dollar liabilities and other nondeposit sources of funds to the banks, it appeared that bank credit in July was weaker than had been anticipated at the last meeting, hence calling for some weight to be given to the proviso clause of the Committee's directive. At the same time, the presence of a Treasury financing, the sensitive state of market opinion, and some continuing uncertainties about the real significance of the indicators used to measure bank credit all argued for a most cautious implementation of the proviso. This implementation took the form of moving more slowly than would have been the case otherwise to offset a little easier tendency in reserve availability in the middle portion of the recent period, as reserve distribution tended to favor money center banks. Thus, from July 18 to 31 daily effective Federal funds rates ranged no higher than 8-3/4 per cent despite sizable System action to absorb reserves.

After August 1 reserves were redistributed away from money center banks, partly reflecting heavy Treasury calls on its major tax and loan account depositaries. In this setting banks bid vigorously for reserves in the Federal funds market--although discount window borrowing was moderate until this past weekend--and the Federal funds rate shot up to levels of 10 per cent or higher despite sizable System reserve injections through repurchase agreements. On several days repurchase agreements were offered in a second round to clean up residual financing needs and to emphasize the Desk's desire to ease the availability of funds, but such was the banks' insistent demand for funds that the rate stayed very high. To be sure, the Account Management could have operated to inject reserves on a still more aggressive scale in terms of volume and timing, and this might have had greater effect in moderating the high Federal funds rate--but quite possibly at a cost of suggesting a more fundamental policy shift than seemed appropriate in the course of modest implementation of a proviso clause in a period of Treasury financing. Yesterday, with the help of heavy borrowing over the past weekend, large reserve excesses were built up, and this contributed to an easier Federal funds market which may well continue today and tomorrow. In turn, this should counterbalance the excessive tautness that prevailed a few days ago.

In the period ahead, with the current Treasury refunding nearly concluded, the market will undoubtedly be watching System policy implementation with more than ordinary care. A Treasury cash borrowing of $1-1/2 to $2 billion is expected to be announced shortly, probably in the bill area and hence requiring minimal even keel consideration. The next refunding operation, to handle the large October 1 maturity, is a little over a month away.

In the meantime, certain special factors may have a particular bearing on money market developments and the implementation of System operations in the period just ahead. One consideration is the adjustment burdens that banks may face in coping with current and immediately prospective System actions to close off, or make less readily available, some of the techniques developed to raise funds outside of Regulations D and Q. To keep these adjustment burdens reasonably smooth, it may be necessary to have considerable leeway in regard to standard measures of marginal reserve availability. Particular flexibility may also be needed in interpreting a proviso clause to allow for possible changes in bank behavior as old loopholes are closed and new ones are sought out.

Another set of factors that may significantly condition near-term operations are those stemming from the franc devaluation and whatever reserve flows or other developments that may now emerge. For example, if there should be major foreign currency swap drawings that inject

> reserves, they could displace the need for System market purchases of securities that might have been appropriate otherwise. And depending on which countries gain or lose reserves, and how they invest or raise the proceeds, a wide variety of foreign account activity is possible.

Mr. Brimmer remarked that in recent weeks a number of banks appeared to have moved into the Federal funds market because they had outworn their welcome at the discount window. It seemed to him that if the Federal funds rate rose to a higher plateau as a result of such a development, it might be undesirable for the Desk to offset the added pressure. He wondered if the Desk was able to trace the movement of individual banks from the window to the Federal funds market.

Mr. Sternlight replied that it was difficult to ascertain the specific sources of pressures on the Federal funds market. In recent weeks some country banks had been asked to curtail their borrowing from the System and had turned to the Federal funds market. He was not aware that any major banks were subject to administrative counseling at the present time. In any event, the extent of pressures on the Federal funds market depended a lot on the composition of the individual banks which found themselves in need of funds at a particular time. Even without a change in administrative pressures at the window, the Federal funds market could be affected by a shift in the banks which were in deficit positions and whose willingness to borrow from the System differed from that of other banks.

Mr. Mitchell asked if there had been a policy decision by the major New York City banks to improve their basic reserve positions. He had noted a decline in their basic deficits from mid-June to the week ending August 6 when the deficit was around zero.

Mr. Sternlight said he thought the New York banks were deliberately trying to improve their reserve positions to keep ahead of liquidity pressures. The New York banks had also increased their takings of Euro-dollars, and that had contributed to their improved basic reserve positions.

In response to a further question by Mr. Mitchell, Mr. Sternlight observed that the peak pressures on the Federal funds market recently, when the effective rate had risen to 10 per cent or more, seemed to stem largely from money market banks located outside New York.

In reply to another question by Mr. Hickman, Mr. Sternlight commented that the New York City banks had improved their basic reserve positions in recent weeks, but they had remained net buyers of Federal funds on most days, including the period when the Federal funds rate rose to above 10 per cent.

Mr. Daane inquired whether the Desk could have acted to prevent the excessive tightness which had developed without giving the market a misleading impression of System policy.

Mr. Sternlight said he felt the Desk had gone about as far as it could without risking the possibility of misleading the market concerning the intent of System policy. A balancing act had been called for and one could argue about the effects of another $50 million or $100 million in System repurchase agreements on a given day. In the period when the effective rate on Federal funds had fluctuated mostly in the 8 to 8-1/2 per cent range, there had been numerous comments about a shift in System policy. The Desk had therefore become very cautious about misleading the market, particularly since the Treasury was undertaking its August refunding.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period July 15 through August 11, 1969, were approved, ratified, and confirmed.

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

Mr. Partee made the following statement concerning economic developments:

> The recent evidence as to the performance of the economy continues too mixed to permit a clear, unequivocal, empirical judgment as to the immediate future. Some broad measures, such as retail sales and Federal spending, remain essentially flat, as has been the case for some months past. Others, including housing starts and, to a lesser extent, manufacturers' new orders seem now to be in a weakening trend. Business inventories appear relatively high and thus make the economy all the

more vulnerable to a faltering in growth of final sales. But employment and income are still growing fairly strongly, despite an inching up in the unemployment rate over recent months, and industrial production is estimated to have continued rising through July at a healthy 6 per cent annual rate.

At the same time, it seems increasingly apparent that the tone of business has changed significantly since last spring. There is now a note of caution in the air--apprehension, even, in some quarters--and one no longer hears the assertion that fiscal and monetary restraint aren't working to cool off the economy. Partly, this may be a matter of easing profits, which apparently turned down in the second quarter both in absolute amount and as a proportion of sales. Partly, it may be a psychological response to high interest rates and declining stock prices, although interest rates aren't really so high relative to current rates of inflation and the stock market decline thus far has been unusually orderly. Partly, the new note of caution may reflect the fact that, though business conditions are still good, there isn't the upward momentum in markets that business in recent years has taken almost for granted. Whatever the reasons, the calming in business and investor psychology that appears to have been in process is an important and necessary accomplishment in our effort to shift the economy to a less inflationary environment.

Evidence of the extent to which ebullient business expectations have been punctured seems to me the most significant by-product of the recent informal Reserve Bank survey of the capital spending plans of large firms.[1] Obviously, the small over-all cutback in capital authorization plans reported by firms other than utilities can't be taken as evidence that any major downturn in capital spending is at hand. But the point is that cutbacks in plans--except for the utilities, where there is a demonstrated shortage of capacity--were reported far more commonly than increases,

[1] Preliminary results of the survey, which included approximately the 200 corporations that were planning the largest expenditures for plant and equipment in 1969, were transmitted to the Committee in the supplement to the "green book," the report "Current Economic and Financial Conditions," prepared for the Committee by the Board's staff.

both for the remainder of this year and for 1970. And the reasons cited for downward revisions often included uncertainties about future business conditions as well as the current tightness of money. These are the very largest firms in the country, of course, and it may well be that funds availability is a more serious matter to smaller corporations.

The Federal Reserve survey was also useful in that it tends to provide additional confirmation that a leveling out in plant and equipment spending is in prospect, as had generally been anticipated. Indeed, the survey findings are not inconsistent with some decline in spending as 1970 progresses, compared with the peak rates expected in this and perhaps the next quarter. Planned authorizations for the second half remain sharply above year-ago levels, but for 1970 a small cutback from the 1969 volume is currently in prospect--again, except for the utilities. While there is a sizable lag before a change in authorizations is ordinarily reflected in actual spending, in most industries it is not so long that the shift wouldn't appear within a 6 to 12 month period. I understand also, very confidentially, that early returns received on the regular official capital spending survey now being processed indicate a moderate further cutback from earlier plans for the current year, concentrated in durable goods manufacturing.

With this new, though still partial, evidence on capital spending, the situation in all major sectors now clearly points to further moderation in economic expansion. In fact, it seems to me that an actual cyclical downturn late this year or in early 1970 has become a real possibility. In the Federal sector, new orders for defense products are on the decline and the budget seems under fairly good control. In housing, residential construction is now falling off, and the funds position of the mortgage lenders suggests that the only question is how much further decline there will be. In the State-local area, too, the unavailability of financing should serve to moderate somewhat what otherwise is a very strong upward trend. Business inventories have been rising substantially, and inventory to sales and to orders ratios are high enough to assure a cutback sooner or later if product demands tend to reopen. Consumer spending on goods generally has been on the weak side for many months. In July, unit sales of both domestic and foreign cars dropped appreciably, and total retail sales advanced only about one-half per cent. Moreover, the relatively low second quarter personal saving rate suggests that there is not much room for further decline, and therefore that consumers aren't likely to prove an independent source of strength to the economy in the period ahead.

In sum, it seems to me that policy has gone a large part of the way towards insuring an economic climate that will be conducive to combating the spiral of inflation. The shift in business and investor sentiment and the reopened demand prospects in all major sectors, in combination, seem to me to yield a high degree of confidence in the probability that an economic slowdown will take place before many more months have passed. Given the lags with which monetary policy works, which are no less real because they are variable and difficult to quantify, I believe that the time has come for the Committee to consider backing off slightly from its current posture of severe restraint. One might hope for more definitive evidence of a business turn, but I fear that we won't have it until too late; and in any event, the Committee will be constrained at its September meeting by Treasury financing considerations. A modest timely move now, as indicated in alternative B of the proposed directives,[1] may help to forestall the need for the marked degree of ease that could be dictated later on by a business recession.

Mr. Keir then made the following statement concerning financial developments:

Recent banking data indicate that monetary policy intensified its bite on the banking system during July. Deposit erosion at banks proved to be substantially larger than expected. And although funds obtained from non-deposit sources showed sizable further growth, these inflows were not sufficient to offset the deepening deposit outflows. As a result, the July bank credit proxy, even after rough adjustment to allow for both Euro-dollar borrowings and other non-deposit flows, still showed a decline of about 7 per cent at an annual rate--compared with a 1-1/2 per cent increase in June.

[1] The draft directives submitted by the staff for consideration by the Committee are appended to this memorandum as Attachment A.

An important feature of the further deposit shrinkage in July was a sharp increase in pressures on banks outside the major money centers. Even country banks, which usually continue to acquire savings in post interest-crediting periods, experienced heavy net losses in savings and other time accounts during July. For the banking system as a whole, although loans showed no net growth for the month, security liquidation continued, and bank liquidity ratios dropped further to levels well below those prevailing during the 1966 period of credit crunch.

Looking ahead to August, staff projections indicate that a continuation of present policy would probably produce a decline in the credit proxy adjusted for Euro-dollar borrowing at about the same rate as in July--that is, nearly 12 per cent. If one assumes that the new Board regulations will cause some tapering-off in non-deposit flows, the August proxy adjusted for both Euro-dollar borrowing and other non-deposit sources might actually show a larger contraction than the 7 per cent July rate. For those who prefer to look at total reserves, the estimate is for further decline at a 15-1/2 per cent annual rate in August, following declines at 8 and 24 per cent annual rates in June and July.

All of these estimates take account of new demand deposit numbers adjusted to eliminate downward bias arising from Euro-dollar transactions. This revision raises the money supply growth rate by 1 to 2 percentage points throughout the first half of 1969. For June alone the annual rate of increase was revised upward to 4.3 per cent from no change in the old series. And for July the revision shows a 6.1 per cent annual growth rate, up from the old figure of 3.7 per cent. In both cases revisions bring the money supply numbers back closer to the initial staff projections made at the start of the period. As for August, when Government deposits are estimated to show little change after two months of sharp contraction, money supply is projected to decline at about a 4 per cent annual rate.

Evidence on deposit shrinkage at banks tends, of course, to exaggerate the extent to which total credit flows in the economy are being affected by monetary policy, particularly when--as in July--the bulk of the contraction reflects shifts of savings away from banks directly to securities markets. However, recent evidence does indicate that System policy has begun to reduce aggregate credit flows as well as growth in bank credit. Thus, the preliminary flow-of-funds data for the second quarter show that total borrowing dropped to an annual rate of $71 billion from the very high first quarter rate of $100 billion. Most of this decline reflected the shift of the Treasury from a net borrower to a large net repayer of debt between the two quarters. But borrowing in private domestic non-financial sectors also declined by nearly $5 billion. And fragmentary evidence since mid-year suggests that the tendency is continuing.

Turning to policy considerations, the overriding question whether now is the time to begin a little moderation in the Committee's over-all posture of restraint has already been raised by Mr. Partee. In the present financial environment there is another, essentially technical, but partly related question on which the Committee may also want to focus. This question relates to the likely effects of the Board's recent regulatory actions. As I understand the various changes adopted or proposed, their objective is not to introduce a further turn of the policy screw on banks, but rather to close loopholes that have given certain banks special advantages in resisting general monetary restraint. If this is the purpose, then the Committee will clearly want the Account Manager to supply the banking system with the reserves needed to comply with the new requirements.

In the application of Regulations D and Q to loan RP's, however, the effect is to phase this type of instrument out, since at present interest rate levels it will no longer be competitive. In these circumstances banks are being forced to cover funds lost by the disappearance of loan RP's--presumably through such things as outright sales of assets, sales of commercial paper through affiliates, and expanded resort to Federal funds borrowing. Although funds previously provided by the loan RP's will, of course, be released for alternative investments, the fact that both loan RP's and the need to meet added reserve requirements under the other Board regulations are concentrated in a relatively few banks is likely to produce substantial frictional pressures in the adjustment process--particularly at banks outside the major money centers.

Already, the Federal funds market appears to be reflecting added demands created by the approaching cut-off date on loan RP's and by the new reserve requirements on deposits associated with Euro-dollar transactions. In these circumstances the prevailing level of the Federal funds rate becomes a particularly sensitive measure of policy intent and is being closely watched as such by market participants.

For this reason it would seem to be especially important to back the funds rate down from the 10 per cent plus levels that have prevailed over most of the past week closer to the 8-1/2 per cent average that prevailed immediately after the last Committee meeting. Such a posture would be consistent with the type of economic outlook projected by Mr. Partee; it would help to moderate the severity of the further deposit contraction that seems likely in the absence of some policy moderation; and it would help to minimize the risk that the new regulatory actions will have a more severe impact on financial markets and general bank liquidity than is presently assumed. In order to maintain a funds rate fluctuating around the 8-1/2 per cent level, it would be necessary at times to let marginal reserve measures flex toward the lower end of the ranges specified in the blue book.[1]

The potential risk of some backing away from the recent policy of cumulative restraint is, of course, that it may over-stimulate the developing hopes of market participants for a general interest rate decline, and conceivably rejuvenate fears that inflationary pressures will not be sufficiently resisted. The chance that such a drastic change would develop from the degree of backing away contemplated by alternative B of the draft directives seems highly unlikely, however, since--in the absence of some other narrowing of current spreads between market rates and Regulation Q ceilings--the moderation of deposit contraction likely to develop is quite limited. On the other hand, adoption of alternative B would put the Committee in a better position to lead into the important post-Labor Day period when signs of easing

[1] The report, "Money Market and Reserve Relationships," prepared for the Committee by the Board's staff. The blue book passage referred to read as follows: "If the Committee wishes to consider somewhat less restrictive money market conditions as a policy alternative, such conditions might include a Federal funds rate fluctuating around 8-1/2 per cent, member bank borrowings ranging between $900 million and $1.1 billion, and net borrowed reserves in a range $100 million - $200 million lower."

in demands for both credit and goods may become more widespread and even keel constraints will be operative.

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

> I would like to address myself today to the relevance of the balance of payments to current and near-term monetary policy.
>
> For some time now balance of payments and domestic considerations have pointed in the same direction: both have called for restrictive monetary policy. The need to improve the U.S. trade balance has merely reinforced the domestic case for cooling the economy and stopping the inflation. The benefits that tight money has brought to the U.S. capital accounts were incidental, though significant, by-products of the basic anti-inflation purpose of monetary policy.
>
> As we look ahead into 1970 the outlook for the U.S. trade balance is not very bright, even if good progress is made in curbing inflation. The cyclical situation abroad is unlikely to remain as favorable to U.S. exports as it is now. Although our imports will no doubt continue to slacken with domestic activity, export growth next year may also slacken as the boom in Europe and Japan cools off. Beyond such income effects, it remains to be seen whether the price advances of the past three years will have altered the competitiveness of U.S. exports and of U.S. domestic output in relation to imports.
>
> Until the prospects for the trade balance look brighter, it will be desirable to minimize net capital outflows from the United States. On this basis one can say that balance of payments considerations taken by themselves would call for maintaining as long as possible a set of credit conditions in the United States somewhat more stringent than those that exist in other major countries--particularly in Europe and Japan.
>
> But monetary policy does not need to be as tight as it has been in recent months in order to have a favorable effect on capital flows. It has become clear that while tight money helps the capital account of the balance of payments there can be too much of a good thing. Too much in the sense (1) that excessive capital

> inflow imposes heavy pressures on some foreign countries and also (2) that the United States does not need a big surplus on official settlements.
>
> On the other hand a marked easing of U.S. monetary policy could lead to substantial outflows of Euro-dollars as well as other forms of capital. A steady policy longer maintained is more desirable, from the balance of payments viewpoint, than too much tightness now followed by too much ease later.
>
> If recent indications of monetary stringency persist--in particular, substantial contraction of total reserves and of the credit proxy--the Committee may find it necessary to ease policy rather sharply later this year or in early 1970. From the balance of payments viewpoint, it would be better to adjust policy now toward a more sustainable posture.
>
> Even if this is done, domestic considerations may at a future time call for a much easier monetary policy than is called for on balance of payments grounds. When that happens it is doubtful that the balance of payments would or should override domestic considerations. For now, however, it is possible to shift Federal Reserve operations modestly toward somewhat less contraction of the monetary aggregates and to justify such an adjustment on both domestic and balance of payments grounds.

In response to a question by Mr. Bopp, Mr. Partee indicated that, although staff members had been exposed to much of the same information and prior discussions, the recommendations contained in the three staff presentations today had been developed independently.

Mr. Brimmer observed that alternative B of the staff draft directives, calling for slightly less restrictive conditions in the money and short-term credit markets, seemed to be an easing directive and would be so interpreted. He wondered if Mr. Sternlight shared that impression.

Mr. Sternlight said he thought that was the staff's intent.

Mr. Partee noted that, although adoption of alternative B would result in slightly easier market conditions, the staff proposal did not intend easing in terms of the monetary aggregates. It was the staff's thought that implementation of alternative B might help to moderate the sharply contractive tendencies which were developing in those aggregates under the prevailing degree of tautness in the money and short-term credit markets.

Mr. Maisel commented that the issue was whether halting an accelerating contraction in the monetary aggregates should be considered as easing. He did not think any easing was involved when--even under alternative B--those aggregates were projected to decline at a faster rate than they had on average over the past six months.

Chairman Martin observed that it was his periodic duty to remind those attending these meetings of the need for confidentiality. Shortly after the Committee's July 15 meeting, a leading newspaper had reported what it alleged to be the essence of the Committee's deliberations and its policy decision. On the same day a foreign correspondent had seemingly quoted materials from Mr. Coombs' presentation. He (Chairman Martin) was not saying that anyone had revealed privileged information, but he wanted to emphasize the need for exercising great caution in conversations with others, particularly in this critical period when attention was closely focused on the System's activities.

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

> In the last few weeks there has been an increasing flow of comment in the press and elsewhere to the effect that the combination of monetary and fiscal restraint is at last taking hold and that the long-sought substantial slowdown in the economy is now clearly in view. I must say that I find this comment disturbingly premature. Of course, there is no evidence at all of any easing in prices or in the wage push; but no one really expected such easing until some months after there had been an adequate slowdown in the real economy. It is the dearth of evidence that an adequate business slowdown is in the making that I find especially disappointing, for this suggests that our fight against inflation still has a long way to go.
>
> The economy remains generally very strong, despite a few scattered statistics pointing the other way. Businessmen are in most instances sticking to their capital spending plans; it is my impression that the changes reported in the Reserve Bank's survey of capital spending plans are minimal and probably of little significance. Inventories remain in pretty good balance, and the labor market is still very tight. State and local spending still seems headed strongly upward, in spite of all the recent difficulties in the tax-exempt market; and our analysis indicates that the Federal budget will be much more stimulative in fiscal 1970 than in the preceding fiscal year. We should not lose sight either of the very large prospective increase in Federal lending programs outside of the budget in fiscal 1970. I am more than ever convinced that it was a serious mistake on the Administration's part not to propose continuance of the 10 per cent tax surcharge throughout the current fiscal year.

About the only major hopeful development in the domestic economy has been a rather less exuberant mood among both businessmen and consumers than prevailed a few months ago. For this we perhaps owe thanks mainly to the sharp drop in the stock market and the apparently worsened outlook for corporate profits--although widening public exposure to tight money has doubtless played a part.

Balance of payments statistics continue to make gloomy reading. The figures on the liquidity deficit are of course fantastically high. Fortunately, a good part of this deficit may reflect reversible heavy movements of funds into the Euro-dollar market and into the German mark. But our favorable trade position, which should be the main element of strength in our over-all payments, remains very weak and will probably not improve much until inflation is fairly well under control. Meanwhile, the French devaluation may bring heavy speculative movements in the recently lethargic exchange markets. For the time being the dollar may continue to be protected by sizable Euro-dollar borrowings by American banks. As we look further ahead, of course, a major threat to the dollar may develop when domestic credit conditions ease and the branch bank borrowings are paid down.

Analysis of the current banking and monetary statistics is extremely difficult and complex in view of the proliferation of nondeposit liabilities and other techniques that have been developed as pressure on the banks has intensified. Because these confusing data seemed to me so crucial to policy formulation, I took the liberty of distributing to the members of this Committee a memorandum that was recently prepared on the subject by our Research Department. After adjustment for these special developments as far as possible, and for subsequent statistical revisions, bank credit appears to have increased so far this year at an annual rate of 4 to 4-1/2 per cent. While the various proxy measures suggest lower or even negative rates of growth, there are reasons to believe that these measures seriously understate the growth of bank credit. Also, as indicated by the new blue book figures, the money supply has probably risen at an annual rate of about 4 per cent so far this year. This contrasts sharply with the 2-1/2 per cent growth rate we had before us at our last meeting, before account was taken of the bank payment practices that led to the revision of Regulation D. The credit growth rate is not far out of line with what we would like to see in the inflationary setting of 1969; and I suppose that a monetarist might find the money supply growth rate rather excessive, as I do.

In view of the dubious evidence pointing to an adequate business slowdown in the coming months, the serious international situation, and the fact that money and credit have been supplied generously enough to support an overheated economy, I can see no reason whatever to depart at this time from our policy of firm restraint. Continued restraint for several more quarters is probably needed if we are to accomplish any material checking of the inflationary spiral. I am concerned that recent market discussion of a possible imminent turn toward greater ease might find encouragement if future System actions fail to convey a clear signal of continuing firmness, and might lead to a speculative upward movement in the bond market that could seriously embarrass our continuing efforts to restrain inflation.

I would favor alternative A of the staff drafts of the directive, with a few minor changes in wording in the first paragraph. For example, in the draft statement on prospective developments, I would delete the words "in the period ahead" on the grounds that the time reference is too indefinite and leaves the third quarter unlabeled. The statement would thus read "and that prospects are for some further moderation." And in the reference to declining interest rates, addition of the word "slightly" would seem to be indicated in the context of the very rapid rate advances earlier. Accordingly, the statement would read: "Most market interest rates recently have receded slightly from their earlier highs."

The unchanged open market policy that I favor would probably involve a Federal funds rate of 8-1/2 to 9-1/2 per cent, bank borrowings of $1 billion to $1-1/2 billion, net borrowed reserves of around $1 billion to $1.3 billion, and a Treasury bill rate about 6.90 to 7-1/4 per cent. But I can see a real problem ahead for the

Manager because of the difficulty of interpreting the money and credit data from day to day and from week to week. Certainly, I sympathize with the spirit of the current proviso. However, the task of adjusting to deviations of bank credit from current projections seems almost insuperable for the coming policy period, and perhaps we might consider omitting the proviso on this occasion. On the other hand, if the Committee would prefer to retain it as a matter of principle, in view of our obvious continuing interest in the credit and money aggregates, I think the Manager would have to interpret it very loosely, since there can be no precision in dealing with credit proxy data in a period in which significant statistical adjustments becloud their interpretation and comparison with earlier periods. The added reference at the end of the second paragraph to possible pressures in connection with foreign exchange developments seems a bit vague, but I have no objection to it if it is understood that the pressures alluded to might counsel modification of policy in either direction.

I suppose a comment on the discount rate would be in order, inasmuch as it remains far out of line with the market. However, I would not advocate a change at this time. Administration of the window has not yet become a problem in our District--though we have been having conversations with a growing number of country banks that have been active users of the facility. My principal reason for opposing an increase is that we have already placed the banking system under severe pressure, so that a further move in this direction is not needed. This consideration is underlined by the fact that a number of steps have been taken or are on the way to close or narrow various escape routes developed by the banks. Also, it may be well to save the discount weapon for possible use at a time when it could be useful as an antidote to misinterpretation of other System actions.

Of course, under present circumstances it is essential to have in mind the effects of Regulation Q when formulating monetary policy. While the rate ceilings have certainly served a purpose in helping to create an atmosphere of severe restraint in the banking system--and while they have also helped to mitigate the impact of tight money on the structurally inflexible thrift institutions--they have also had a number of undesirable results. By tending to concentrate

> monetary restraint in New York and a few other money centers, they have led to very sharply augmented pressure on the Euro-dollar market. The larger the American banks' takings from the Euro-dollar market become, the more embarrassing may be our position when a reversal occurs, as Mr. Hersey stressed at the Committee's July meeting. Also, the escape "gimmicks" spawned in great variety by the ceilings are in many instances undesirable in themselves, as the Board has recognized in several recent actions and proposals. No one could foresee that the CD, which had, I believe, become a useful banking development, would shrink in aggregate volume as rapidly as it has. Most New York banks now expect their CD's to disappear for all practical purposes.
>
> I think we are close to the point where some revision of the ceilings is indicated in order to avoid further attrition--always with the proviso, however, that we are confident that this will not be generally interpreted as a sign pointing toward less restraint. Possibly, this might be accomplished by removing the ceilings on the volume of large CD's outstanding at a very recent cut-off date at the individual bank concerned, while retaining them for any excess. Alternatively, consideration might be given to raising or even removing the ceilings only on the longest maturities. Time does not permit a full discussion of these alternative courses right now, but I believe the Board should be giving them their close attention in the next few weeks, before the Treasury's October refunding again confronts us with the need for avoiding overt actions in order to provide an even keel atmosphere.

Mr. Morris said he thought it would be well at this point in time to focus on the longer-run objectives of Federal Reserve policy. A key issue was whether the Federal Reserve was still following a policy of "gradualism," as enunciated earlier this year by the Administration and by Federal Reserve spokesmen. Such a policy would seek to dampen inflationary pressures in a gradual manner over a period of time without generating recession levels of unemployment. The question now was whether System policy had been modified in recent months, and whether the Committee was now following a policy designed to produce a faster response in the price level in 1969 at the risk of producing a modest recession in 1970.

Mr. Morris said he raised that question not only because he thought it was crucial in deciding between alternatives A and B of the staff's draft directives, but also because he believed that a policy of gradualism represented a good long-range policy for the United States. He was concerned that, although the policy had not been formally repudiated, the term "gradualism" had disappeared from the Washington vocabulary.

If Government authorities had simply stopped talking about gradualism, Mr. Morris continued, that was good strategy because the specter of recession had a healthy influence on business expectations. But if the policy itself had been abandoned, that was another thing; he believed that it was a policy well suited to an economy with the great growth potential of the United States and to a society with the massive social unrest of the United States.

Mr. Morris felt that the policy of gradualism had been abandoned so far as monetary policy was concerned. The monetary policy followed from December through May was one of gradualism. Since May, he thought monetary policy had drifted into a position of substantial restraint which was every bit as severe as in

1966. He used the term "drifted" because the change was produced in large part by the momentum of the original policy of moderate restraint rather than by a conscious decision on the part of the Committee and, in part, it was the result of a diversion of energies toward closing loopholes opened by an ingenious banking community.

At this critical juncture, Mr. Morris continued, the Committee found its statistical yardsticks in disarray. The money supply had just been redefined and there was no longer a working consensus as to the meaning of bank credit. One of the few yardsticks that had not been redefined was bank reserves. With respect to that yardstick he wanted to make two comments. First, since May total bank reserves had been contracting at a 16 per cent annual rate. It was axiomatic, he thought, that such a decline could not be continued for long without generating severe financial disruption. Second, the decline in reserves had proceeded at a substantially greater rate than initially forecast. The initial forecasts for June, July, and August indicated an average decline at an 11 per cent rate rather than a 16 per cent rate. The August projection had already been revised downward since early August from a 13 per cent annual rate of decline to a 15.5 per cent rate. Certainly, in terms of bank reserves, there had been a more restrictive policy than the Committee had originally contemplated.

Mr. Morris observed that the issue for this meeting was not whether a policy of restraint was needed; the issue was the degree of restraint that was required. He had taken the position at the last meeting that the Committee should adhere to a policy of restraint until it could see a pronounced and widespread weakness in the leading indicators--something that had not yet occurred. Nevertheless, he was concerned that the Committee was embarked on a policy course which would, if adhered to, generate excessive financial restraint and an excessive reaction in the real economy in the first half of 1970.

Mr. Morris noted that he was confident the Committee would have to modify its policy at one of the next three meetings. The issue was whether a very small step should be taken now, along the lines of alternative B, or whether a more precipitous step would be taken later on. If alternative B were adopted, he would be perfectly willing to reverse that step if the business statistics of the next two months did not conform to expectations. In his view monetary policy could and should be used as a more flexible instrument. He appreciated that implementation of alternative B could very well have an unfortunate impact on market expectations, but at this point in time he thought that was in fact the lesser risk.

For the foregoing reasons, Mr. Morris said he would favor alternative B of the draft directives.

Mr. Coldwell reported that recent changes in Eleventh District economic trends had reflected strength in employment, personal income, and industrial production, but a plateauing of retail trade and construction. Agricultural conditions had deteriorated as dry, hot weather had continued and prospects for dry land crops had weakened. Prices had begun to slip for most farm products, especially cattle. The number of cattle and calves on feed in Texas continued to rise and in June, at 1,198,000 head, was 60 per cent above a year earlier and 6 per cent over the prior month.

Mr. Coldwell said that major balance sheet items for the District weekly reporting banks in the four weeks ended July 30 generally were weaker than in June or July 1968. However, the decline in loans in the recent period was more than accounted for by sales of loans as banks acquired funds through nondeposit sources, and the declines in demand and time deposits were offset by increased Euro-dollar and other borrowings, especially net purchases of Federal funds.

To a considerable extent, Mr. Coldwell continued, Eleventh District trends appeared to mirror those in the national economy. Perhaps the important change of the past month had been the seasonal slackening in activity and the settlement of several uncertainties including the surtax extension, announcement of the Treasury refunding terms, and House passage of a tax reform bill. Those developments had combined to bring about an improved market psychology which seemed to lay stress upon a slowing of certain credit demands and was associated with a market appraisal that the period of peak pressures was passing and with the beginnings of investor interest in longer-maturity debt instruments. The banking system appeared to be under somewhat less pressure than before, perhaps because of greater use of nondeposit sources of funds, the application of tighter loan standards, and the shift of funds to money market banks.

In reviewing the change in market psychology and the factors causing it, Mr. Coldwell said he was still impressed by the lack of change in the fundamentals of the economic situation. Production was still advancing and a base of enlarged personal income was developing the purchasing power for a renewed surge in personal consumption. Business capital spending programs were under intensive review, not in the sense of an actual reduction but only of a less rapid advance. His interpretation of the Reserve Bank survey results closely paralleled that of Mr. Hayes.

Mr. Coldwell observed that bank credit was becoming less available and more costly, but banks were still making loans even for corporate acquisitions and were finding funds from a wider variety of nondeposit sources. It was his impression that the ceiling rates under Regulation Q were being avoided and evaded with increasing regularity. If the sales of loans by banks were considered, he doubted that there had been much of a real decline in bank credit.

Thus, in appraising the recent posture and future prospects of the economy, Mr. Coldwell was persuaded that only a very tight rein would prevent a renewed outburst of activity and further inflationary pressures. Therefore, he would prefer no semblance of easing, either deliberate or by inadvertence. The conditions he would aim toward in the money and short-term credit markets would be characterized by a Federal funds rate persistently above 9 per cent and preferably averaging around 9-1/2 per cent, a Treasury 91-day bill yield of 7 to 7-1/4 per cent, member bank borrowings between $1.1 billion and $1.4 billion and net borrowed reserves of $1.1 billion to $1.2 billion. He would prefer a System stance involving a persisting tight rein on reserves rather than any overt move. Thus, he would discourage a discount rate change. He would pay less attention to the credit proxy and other similar measures because he thought the use of Euro-dollar borrowings and nondeposit sources of funds was distorting their meaning. Of greater importance to the present circumstances, he thought, were the attitudes and expectations of the banks and money and capital market participants and those were best influenced in the short run by the interest rate on reserve adjustment devices and by the banks' borrowing positions. Nevertheless, he thought the persistent upward movement of Federal funds rates should generally be limited to about 10 per cent.

Mr. Coldwell said he would support alternative A of the draft directives. However, he questioned the desirability of reintroducing a reference to prospective economic conditions in the first sentence of the directive. He had the same reservations as Mr. Hayes concerning the interpretation of the reference to "the period ahead" and in his view the entire statement about economic prospects should be deleted from the directive.

Mr. Swan reported that the unemployment rate for July was unchanged in California and it declined by one-tenth of a percentage point in the State of Washington. In contrast to the national experience, member bank borrowings in the Twelfth District were less than half as large in July as in June, reflecting declines in six successive weeks both in dollar terms and as a percentage of the national total. Borrowings were up again in the first week of August, however. Commercial and industrial loans at the weekly reporting banks declined in July, possibly reflecting constraints on the supply of funds, but some of the major District banks indicated that loan demand was somewhat less in July than they had expected and that the situation might persist in August. However, he was unable to get any firm estimate as to whether the loan decline was of seasonal proportions or less. There had occurred sizable losses of large-denomination CD's and of other time and savings deposits at weekly reporting banks in each week of July. Also, information from a few savings and loans associations suggested that savings outflows had continued through the entire month instead of tapering off as expected after July 10.

Turning to policy, Mr. Swan indicated that while he agreed with those who saw little reason in the recent economic statistics to change policy, he also felt that there had been some shift in business and investor sentiment. He was firmly convinced that there was no basis for any additional firming either through open market policy or as a result of the adoption of various new regulations designed to close loopholes. It seemed to him that the Committee should not allow the effectiveness of the new regulations to result either deliberately or inadvertently in any tightening.

Turning to the directive, Mr. Swan commented that he had reservations about both alternatives A and B of the draft directives. He could not at this point quite bring himself to support an overt move toward ease as was implied in alternative B. With respect to alternative A, he was happy to see the suggested deletion of the word "currently" from the phrase "currently prevailing firm conditions" in the previous directive. He did not think that the money market conditions of the past week should be maintained. On the other hand, he would be happier with alternative B if it could be interpreted as an accommodation of easing market forces rather than as an instruction to achieve less restrictive conditions. In other words, he would hope that even if the Committee adopted alternative A the Committee's policy would not be interpreted to mean that any market movement in the direction of ease would necessarily be fully offset in order to maintain present conditions. Accordingly, he felt he was left with an unsatisfactory choice between the two alternatives. In terms of the money and short-term credit market conditions associated with each alternative in the blue book,[1] he did not see that any really significant differences were involved, particularly if--as he suspected--there was a tendency for actual conditions to emerge at the easier end of the alternative A ranges.

[1] The blue book passages referred to by Mr. Swan read as follows: "...maintenance of prevailing firm conditions in the money market may be considered to entail a Federal funds rate averaging around 9 per cent, member bank borrowings in a $1 billion - $1-1/2 billion range, and net borrowed reserves around $1 billion....the 3-month bill rate may continue in a 6-3/4 - 7-1/4 per cent range over the next four weeks."

"If the Committee wishes to consider somewhat less restrictive money market conditions as a policy alternative, such conditions might include a Federal funds rate fluctuating around 8-1/2 per cent, member bank borrowings ranging between $900 million and $1.1 billion, and net borrowed reserves in a range $100 million - $200 million lower....the 3-month bill rate may move down into a 6-1/2 - 6-7,8 per cent range."

Mr. Swan added that he had some changes to suggest in the first paragraph of the draft directive. He felt the reference to the balance of payments on the official settlements basis was too obscure and his preference would be to indicate whether a surplus or a deficit had been realized in July. With respect to the statement of the Committee's general policy position at the end of the first paragraph, he understood the staff's argument for the suggested deletion of the word "more" from the phrase "with a view to encouraging a more sustainable rate of economic growth."[1] However, he was afraid that omission of the word "more" at this time might give rise to a misinterpretation of the Committee's intent, and accordingly he would argue for its retention.

In a concluding comment, Mr. Swan said that he would not want to see the proviso clause deleted from the directive, regardless of which alternative, A or B, was adopted.

Mr. Galusha commented that the most recent data for the Ninth District were moderately reassuring. There were indications that the pace of the economic advance had slowed and would slow further

[1] An explanatory note accompanying the staff suggestion for the deletion read as follows: "The suggested deletions from the phrase 'with a view to encouraging a more sustainable rate of economic growth,' especially of the word 'more,' are proposed in order to avoid the possible implication that the 2-1/2 per cent growth rate of the first half of 1969 is considered to be too high to be sustainable over the long run."

as the year went on. The rate of increase in total District employment had declined. Of particular significance, manufacturing employment did not increase at all in the second quarter, and average hours worked in manufacturing also remained unchanged. Until a few months ago, total manufacturing employment and average hours worked had been increasing quite rapidly.

Mr. Galusha also noted that sales expectations had moderated according to the Minneapolis Reserve Bank's most recent survey of District manufacturers. Three months ago District manufacturers were expecting sales for the second half of 1969 to be up about 15 per cent from a year earlier. Now, however, the expectation was for an increase of about 6 per cent. And, not surprisingly, the building outlook was more bearish than it was earlier. From the first quarter of this year to the second, new building contracts and building permits, for both residential and nonresidential buildings, had decreased markedly--on the order of 20 per cent.

Mr. Galusha said he wished conditions in the Ninth District reflected those in the nation. They did not, but even so he was now rather more convinced than a month ago that the future would show that Mr. Partee and his associates were largely correct in the outlook they had presented at the last chart show.[1] For what it was worth, he had lately found

[1] The chart show presentation by the Board's staff was made at the Committee's June 24 meeting.

something of a change of mood among businessmen; and, what was of more immediate significance, he had had a few reports of some changes in their spending plans.

Mr. Galusha observed that he was of two minds this morning and both were apprehensive. August was no longer his favorite month to talk about monetary policy. Yet all things considered, it might be best, he thought, if the Committee were to moderate slightly--and he would emphasize the word "slightly"--the extreme policy of the last few months. He favored alternative B of the draft directives, and the monetary targets associated with that alternative in the blue book. He did not think that adoption of alternative B would make all that much difference, but he felt it should provide increased assurance that monetary conditions would not, by accident, get even more restrictive. That would seem especially important now, during a period when the Board's new administrative regulations were becoming effective. He thought a posture of persistent restraint was important, but he was opposed to further tightening, and he feared that adoption of alternative A would result in such tightening.

Mr. Galusha also indicated that he hoped the Board would consider increasing rate ceilings on large-denomination CD's sometime soon. Admittedly, there could be an unfortunate psychological reaction. But if Committee policy remained about as restrictive as it had been, it was possible that expectations might soon change back nearly to what they had been. What had worried him for some time was that the effective rate ceilings had resulted in the loss of real knowledge about what was going on in credit markets. It was enough to be reminded of the numerous adjustments that the staff had been making in various statistical series--adjustments which, despite the staff's best efforts, were nevertheless of uncertain reliability. Mr. Galusha added that he endorsed Mr. Hayes' comments concerning the need to retain the present discount rate.

Mr. Scanlon remarked that clear evidence of a significant slackening of pressures on resources in the Seventh District was still lacking. There were occasional comments that the pace of activity was moderating but the supporting evidence was not apparent. Indications of slowing in the rate of expansion were largely restricted to the behavior of unemployment compensation claims and permits for single family homes.

On the other hand, Mr. Scanlon continued, orders for most types of machinery and equipment had remained strong in May and June and had continued to exceed shipments. The Chicago Reserve Bank's survey of capital expenditure plans of large firms headquartered in the District showed little or no evidence of curtailments directly related to borrowing costs or credit availability. Increases in prices continued to be very numerous--especially for metals and metal products. Construction contracts in the area were 10 per cent above a year earlier in June, offsetting a decline in May. Auto assemblies were scheduled at 1.6 million for the third quarter, up 8.8 per cent from 1968, but industry analysts were beginning to see some softening in automobile demand in the next few months. Orders and sales for air conditioning and mobile homes were exceptionally strong. Steel output and shipments had been high in the summer despite labor shortages, and a seasonal upswing was expected in September. The growth of steel imports had diminished, and foreign demand for U.S. steel remained stronger than expected. Consumer inventories of steel were reduced in June to the lowest level since January 1968.

On the basis of the more extensive information available on the national scene, it appeared to Mr. Scanlon that there were somewhat stronger indications of possible slowing in the rate of the economy's expansion. The continued decline in the rate of growth of real output nationally in conjunction with virtually no increase in the labor force and a slight rise in the unemployment rate suggested some easing of pressures on resources.

Mr. Scanlon noted that while midsummer readings of the financial barometers were often misleading and caution was called for, the available evidence suggested that credit demands might be easing a bit. The recent weakness in bank loans seemed greater than could be attributed to banks restricting credit and selling loans. Business loans of the large District banks had dropped sharply in July, with borrowing by retailers showing a relatively large decline. Furthermore, growth in both real estate and consumer loans had slowed markedly in recent weeks.

Meanwhile, Mr. Scanlon added, the large Chicago banks continued to reduce other earning assets--especially municipal securities--to offset continued deposit losses, although they had retained the new tax bills somewhat longer than usual. They had reduced their reliance on the Federal funds market as other nondeposit sources of funds had grown and they had managed so far to stay out of the discount window except for occasional small amounts. The new restraints due to the recent amendments of Regulations D and Q would have a sizable impact in one or two cases, but on the whole, District banks did not appear to have a large amount of RP's on loans or securities that would be affected.

Mr. Scanlon thought recent trends in aggregate money and credit series continued to appear consistent with the Committee's policy objective of slower real growth and lessened pressures on the labor market. The Chicago Reserve Bank's staff was projecting a slowing of output comparable to that of the green book and he considered that to be an acceptable target. Given the longer lag in affecting prices, some moderation in price pressures should appear in the next few months. Indeed, in light of the long length of that lag, he felt the Committee should be careful not to overstay a policy aimed at slowing prices at the cost of excessive retardation in real growth and employment. But he did not feel that it was necessary to make a policy change at this time.

Specification of money market targets could be particularly dangerous at times such as these, Mr. Scanlon observed, and he would be willing to permit the Manager considerable freedom to achieve a policy prescription that provided about the present degree of firmness but that definitely resisted any move in the direction of greater firmness. A slowing of credit demands would reduce pressures on the financial markets, lowering interest rates and, if that occurred, the Committee should not try to offset it.

Mr. Scanlon said he believed his views on the directive were similar to those of Mr. Swan, but, on balance, he favored alternative A in the current circumstances. He assumed that alternative A would give the Manager adequate latitude to accommodate the increase in required reserves generated by the Board's recent regulatory changes.

At this point in the go-around, Chairman Martin noted that Mr. Clay was unable to attend the meeting and that Mr. Tow would present Mr. Clay's report.

Mr. Tow then read the following statement:

> The key issue at the moment is the degree of credit restraint that is appropriate. The continuing need for

> restraint can hardly be in doubt. Price inflation remains a frustrating problem and, despite some evidence of improvement, shows little sign of abatement. In addition to the price record, current and prospective wage settlements combined with substantial pressure on manpower and other resources point toward continuing price inflation in the months ahead. It also is very difficult to construct a convincing case that price inflation expectations are diminishing. A lessening of price inflation depends upon the presumption that the restraining forces at work will result in a weakening of over-all demand and easing of resource use sufficient to bring the desired results over time.
>
> The financial impact of monetary policy has been quite pronounced. The various innovations that have been instituted by the commercial banks to obtain funds make it difficult to produce an accurate assessment of the situation. Among Tenth District member banks, as elsewhere, there now is evidence of more widespread liquidation of time and savings deposits. On balance, larger banks are losing consumer time and savings deposits, along with large CD's, while combined time-savings deposits in country banks apparently have ceased to grow in recent weeks. There is great variation among individual banks, however. One of the city bankers reported the sale of a sizable block of his bank's loans to one of the savings and loan associations in his city a few days ago.
>
> In view of the reduced liquidity of the commercial banking system and the economy, contraction of member bank reserves at the rate experienced in July would not be tolerable for very long. The projected contraction for August is smaller but still on the high side. It probably will be necessary to offset the restrictive effects of the new Federal Reserve regulatory actions during their implementation. Moreover, if the recent tendency of the Federal funds rate to move upward continues, open market operations should be used to temper that tendency. At the same time, in view of the continuing inflationary economy, it would be desirable to avoid any overt sign of easing or of basic change of policy.

Mr. Tow said that alternative A of the draft directives appeared consistent with Mr. Clay's views.

Mr. Heflin reported that activity in the Fifth District appeared to have slowed somewhat in recent weeks, although unusually heavy rains in many parts of the District might have been partly responsible for the moderation. Each of the Richmond Bank's last two surveys showed reductions in manufacturers' new orders and backlogs and a slackened pace of both general retail and automobile sales. Residential construction was also reported to have softened further and there was evidence of some cutbacks in commercial and industrial building as well. Nearly half the businessmen in the survey panel now said that they expected some decline in the level of business activity and the Richmond Bank's directors reported an increase in the number of businesses lowering their sights on capital and inventory plans. On the other side of the picture, some businesses apparently had had to revise their capital plans upward because of earlier underestimates of cost and price increases.

Signs of moderation were also present in the national data, Mr. Heflin said, although it seemed to him that there was still abundant evidence of considerable forward thrust in the national economy. Despite the July increase in the unemployment rate, most of the key coincident indicators had continued to turn in a robust performance and there was no visible weakness in the composite leading series. Even though businesses might be trimming their capital plans, evidence on the extent of cutbacks in that area remained indecisive and, in any case, it could be as much as six months before expenditures were affected. Meanwhile, the Committee had to continue to face the problem of upward pressures on prices and costs and the danger of another takeoff of inflationary expectations.

Mr. Heflin added that financial markets appeared to have steadied somewhat recently despite the steep decline in the bank credit proxy and the Desk's close control over reserve growth. Nevertheless, it seemed to him that the underlying tone of the markets continued to be dominated by a high degree of uncertainty. In particular, he believed it was premature to assume that any firm evidence had been seen either of a significant reduction in credit demands or of growing expectations that yields might have peaked. The rather sharp decline projected for the bank credit proxy in July and August bothered him, but in view of increasing bank reliance on nondeposit sources of funds he was not quite sure just how the latest figures should be interpreted.

As for policy in the coming period, Mr. Heflin said he continued to feel that the crux of the Committee's problem lay in the area of prices and price expectations. While there was good evidence that progress had been made in dampening the business community's overexuberance, the recent markups in metals prices suggested to him the Committee was not yet out of the woods.

For that reason, he was unwilling to support any move that might be interpreted by the market as a relaxation of policy. When there was firmer evidence of a significant reduction in credit demands and when the Committee had a better measure of current bank credit growth, it might be appropriate to instruct the Desk to acquiesce in any market easing that might develop. For the present, however, he considered the problem of inflation and inflationary psychology to remain sufficiently serious to justify the risk of overstaying the Committee's current tight policy. Accordingly, he favored maintaining the present degree of market restraint although he believed the Desk should be given latitude to accommodate any unusual pressures money market banks might encounter as a result of the new reserve regulations as well as market pressures that might arise from the franc devaluation. He believed that could be accomplished under the language of alternative A.

Mr. Mitchell expressed his agreement with the analyses presented by the staff at today's meeting and he indicated that he could endorse much of what had been said by Messrs. Morris, Swan, Galusha, and Scanlon. In particular, he was concerned about the current sharp declines in monetary aggregates and he believed that continuation of such declines could lead to disastrous consequences.

Turning to the directive, Mr. Mitchell observed that the significant difference between alternatives A and B of the draft directives was the introduction of new language referring to the monetary aggregates in the second paragraph of alternative B. In his view it was important for the directive to include such language even though he recognized that its adoption would raise problems of interpretation.

Mr. Mitchell said he thought the Committee would not want the Desk to conduct its operations in a way that would lead the market to conclude that some easing in the Committee's policy had occurred. At the same time, he believed the Committee would agree that the contraction in the monetary aggregates should not be allowed to get out of control. With those objectives in mind, he would propose the following language for the second paragraph of the directive: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to moderating contractive tendencies in monetary aggregates while maintaining the position of firm over-all credit restraint; provided, however, that operations shall be modified if pressures arise in connection with foreign exchange developments."

Mr. Mitchell noted that he had two points to make concerning the wording of his proposed directive. First, he would be prepared to substitute specific references to total reserves or to the money stock for the more general reference to "monetary aggregates." He would argue against a specific reference to the bank credit proxy, however, since he felt that that measure did not accurately reflect current bank credit developments and thus was not an appropriate guide for operations. He had left the general reference to "monetary aggregates" in his suggested draft, so as to accommodate varying preferences among members of the Committee as to which aggregates should be given attention.

His second observation, Mr. Mitchell continued, related to his suggestion for including in the directive the language "while maintaining the position of firm over-all credit restraint." He would be prepared to accept in the place of such language the wording of alternative A, namely, "with a view to maintaining the prevailing firm conditions in money and short-term credit markets." However, he thought his suggested language would be preferable.

Mr. Daane indicated that his policy preference was to maintain a steady course at this time. He recognized that there were semantic problems involved in trying to define such a course, but he felt that adoption of alternative B would be interpreted as a shift toward ease. It would be quite unfortunate, he thought, if the public were to be given the impression that the System was shifting gears and moving away from its present policy of firm over-all credit restraint. Recognition of such a shift would have undesirable consequences at home and abroad and in particular would adversely affect the constructive change that had finally been effected in business and investor psychology.

Mr. Daane added that he too would not want to see the development of any further restraint. He was aware of the lagged effects of policy and of the sizable declines that had occurred in various monetary aggregates. Another factor complicating policy was the uncertain state of the foreign exchange markets since the French devaluation; those markets had performed relatively well in the last two days but one could not be sure about the future.

Mr. Daane said he came out in favor of alternative A. Operationally, he would give the Manager maximum flexibility to take account of developments in the foreign exchange markets and to ward off the possible development of excessive tautness in the money market. Within the constraints of this directive, he thought the Manager could also keep an eye on the performance of the monetary aggregates.

Mr. Maisel commented that two different questions had been raised today and he did not think there was much agreement concerning either one. The first related to the immediate direction of the Committee's basic policy, or more specifically, to what were proper short- and intermediate-term objectives of policy. Would a continuation of current market conditions simply mean continuing the current level of monetary restriction or would it mean a further tightening as evidenced either (1) by a decline in the monetary aggregates or (2) by constant money market rates as market demand for funds decreased or as the market came to expect lower rates in the future? The disagreements are brought into sharp focus by a period of three months with a Federal funds rate ranging between 9 and 9-1/2 per cent and net borrowed reserves averaging over $1 billion, accompanied by a 16 per cent annual rate of decline in total reserves.

The second question, which Mr. Maisel found to be the critical issue, was whether or not the Federal Reserve could make any mid-course correction without giving the appearance of a basic policy shift. The Committee had reason to fear that any change would be taken as a shift in policy. However, in another area of endeavor--the space program--attitudes apparently were different; it was realized that corrections in trajectory courses had to be made. In the area of monetary policy the longer the Committee waited, the more difficult a correction would be and the more numerous the problems associated with it.

Mr. Maisel added that the Committee should not lock itself into a position of not making minor changes in the direction of policy. He thought it was the point of Mr. Mitchell's position that a correction could be made. The directive proposed by Mr. Mitchell would instruct the Manager to moderate the current tendencies for the monetary aggregates to contract and, if necessary to achieve that objective, to allow market conditions to change so long as market expectations concerning policy were not unduly affected.

Mr. Maisel concluded that a change in policy could be made at this point and he would favor the directive suggested by Mr. Mitchell.

Mr. Brimmer said he foresaw a continuation of substantial inflationary price pressures into 1970. The Committee's objective of curbing such inflation implied the need to reduce the rate of real growth in GNP. He did not disagree with the staff economic forecast in the green book, and, on balance, he believed the kind of moderation implied in that forecast would lead to some easing of price pressures. However, the GNP deflator was still expected to be rising at an annual rate of over 3 per cent in the second quarter of 1970 even though real output was projected to be declining by the first quarter of the year. Moreover, he thought the Committee should not overlook the possibility of sizable tax reductions stemming from the tax reform legislation, although it was still too early to predict the exact amount of such reductions.

Turning to the directive, Mr. Brimmer observed that the staff had given the Committee two clearly defined alternatives.

He was prepared to vote for alternative A as drafted. He did not see any advantage in the efforts made today to modify the directive in a manner that would prevent the Committee from making a clear-cut choice between a "no change" directive and one calling for some easing. In his judgment, any change in System policy should be overt rather than inadvertent. Moreover, he did not think the Committee should change its operating techniques at this time by focusing on the monetary aggregates as Mr. Mitchell had suggested in his proposed directive.

Mr. Brimmer added that adoption of alternative A today--which he viewed as the cautious policy course--did not mean the Committee would be frozen into its present policy stance until well into October because of Treasury financings. If circumstances dictated, the Committee could hold a special meeting before the one scheduled on September 9 for the purpose of reconsidering its directive.

In a final comment Mr. Brimmer noted that the issue of "gradualism" referred to by Mr. Morris was quite important. Earlier, he (Mr. Brimmer) had thought it most unfortunate that various officials had made a public commitment to a policy of gradualism independently of other objectives. He was pleased that little had been heard about such a policy in recent months.

Mr. Sherrill cited three recent developments which in his judgment argued against any increase in the present degree of monetary restraint. The first was the passage of legislation to extend the surtax. The second was the amount of built-in restraint already in train, especially as evidenced during the past 30 to 60 days. And the third was the apparent change that had occurred in business expectations.

Mr. Sherrill indicated that the Committee should be careful not to permit further restraint to develop through inadvertence. On the other hand, he perceived a considerable risk in any overt move toward ease. The recent reaction of the stock market to an unfounded rumor illustrated how the slightest excuse could trigger a renewed upsurge in inflationary business attitudes. It was clear that there was quite some way to go before the situation was brought under control. The Committee's immediate problem was how to maintain the current position of firmness without allowing more restraint to develop or, alternatively, without creating the impression that a move toward less restraint had been made.

As he viewed the alternative directives and the policy discussion today, Mr. Sherrill thought the Committee members were trying to balance off the necessity for maintaining the current degree of tension in the markets against the need to prevent the monetary aggregates from getting into a position of much greater restraint. While the simultaneous achievement of both objectives would be the Committee's preference, the possibility of a divergence had to be faced and the Committee therefore had to make a decision on priorities. His own preference would be to adopt alternative A as drafted by the staff. He would interpret such a directive as an instruction to guard against the development of increasing restraint from market forces. If loan demands should fall, he would allow interest rates to decline in reflection of the lessened market pressures. Otherwise, he would maintain current market conditions unless the resulting decline in the monetary aggregates became so large as to create a significant increase in the degree of monetary restraint.

Mr. Hickman recalled that in recent meetings he had expressed the minority view that present monetary policy was too restrictive, in the sense that it would lead to an unacceptable contraction in real economic activity before inflation was brought under control. By an unacceptable contraction, he meant one so sharp that the System would be forced into a position of ease while prices were still rising. That would induce a further rise in prices, which the Committee was seeking to prevent. As he read the green book, the conditions that he hoped to avoid were exactly what the Board's staff now projected for the first half of 1970. Economic conditions were appropriate for a modest first step towards a less restrictive monetary policy, and the sooner the Committee took that step, the more likely it was that it could prevent an abrupt swing to extreme ease while prices were still rising.

Mr. Hickman believed the latest economic information provided additional support for the position that a modest adjustment in present policy was appropriate: unemployment rose slightly in the second quarter and in July; outlays for residential construction were off for the fourth straight month in July; and, for the fourth consecutive quarter, real GNP increased less than productive capacity. The demand for business loans appeared to have moderated and corporate bond financing had subsided. Moreover, the Cleveland Reserve Bank's recent survey of planned capital appropriations suggested that financial demands of large manufacturing firms would subside in late 1969 and in 1970.

Mr. Hickman noted that the Committee had an interval of a few weeks before the period of the next Treasury financing, which provided an opportunity to back off a bit from the policy of severe monetary restraint that it had been following. Present policy had resulted in three consecutive months of decline in the reserve aggregates and four consecutive months of decline in the credit proxy--including in each case the August projections. Continuation of the present course would only deepen the recession now predicted by the Board's staff for 1970. The delicate state of the foreign exchange markets also lent support to the argument for a modification of present policy.

Since the Committee had moved so far in the direction of restraint, Mr. Hickman continued, it would not be easy to move even modestly in the opposite direction without touching off exaggerated changes in market psychology and expectations. What he would like to see achieved was a very gradual backing off from present excesses--on the order of moving from a 10 per cent rate of decline in July in the credit proxy, adjusted for Euro-dollars and nondeposit sources of funds, to a decline of about 5 per cent in August, to no change or small positive growth in September, and to a sustainable growth rate in the range of 2 to 4 per cent in the fourth quarter. But again, the longer the Committee delayed, the more likely it was that it would be forced to swing in one single month from a change in bank credit of minus 10 per cent to plus 10 per cent, or more, which would be interpreted here and abroad as a signal that the Federal Reserve System had settled for inflation as a way of life.

Mr. Hickman said he would leave the discount rate and Regulation Q ceilings unchanged for the present, and he would favor either alternative B of the draft directives or Mr. Mitchell's revision.

Mr. Bopp observed that one interpretation of financial developments during the past several weeks was that the inflationary psychology at long last was being turned around. Thus, even though the credit proxy had declined more rapidly than expected three weeks ago and although the money supply had grown at the low end of the range projected in the blue book, money market conditions did ease a bit. And, in recent weeks, corporate bond markets seemed to have stabilized in spite of heavy calendars. It could be that financial markets were beginning to reflect a change in the widespread attitude that inflation was inevitable.

There was also scattered evidence of a nonfinancial nature to support that belief, Mr. Bopp said. In particular, he was thinking of the rise in unemployment in July, the decline in new factory orders, and continued sluggish retail sales. In the Third District, the Philadelphia Reserve Bank's July business outlook survey showed that the belief of a slowdown was prevalent among Third District manufacturers. The percentage of businessmen anticipating lower levels of general business activity six months ahead was almost 80 per cent.

However, Mr. Bopp continued, a less optimistic interpretation of recent financial developments was that declines in short-term rates and the easing of money market conditions were largely a result of funds drawn from the stock market in search of a temporary haven. And, while some of the economic indicators were providing encouraging signs that the results of the policy of monetary restraint finally were being communicated from the financial to the real sectors of the economy, too many others were not. He was not as yet convinced that much optimism was warranted.

It might be that expectations about inflation were being reversed, Mr. Bopp said. It might be also that the policy of monetary restraint was being communicated increasingly from the financial to the real sectors of the economy. But, even if that turned out to be true, the Committee was still a long way from being out of the woods. An end to the price increases was not yet in sight. His Bank's own local survey of manufacturers showed that most of them still looked for more inflation six months from now. In view of the recent Federal pay increases and the over-all strength in the economy he saw thus far, third-quarter GNP increases were almost certain to be larger than he would wish. Even though indications now were that consumer spending beyond the current quarter would be sluggish, that was by no means a sure thing, especially if the surtax was reduced or lapsed at the end of the year.

Mr. Bopp pointed out that at some time it would be necessary to run the risk of moving away prematurely from the present policy of restraint. Otherwise, waiting until it was certain inflation had been brought under control would probably mean the Committee was too late to prevent a recession. Nevertheless, events of the past several weeks did not persuade him that this point had yet been reached. The risks of premature relaxation were still too great. The recent devaluation of the franc and the continuing U.S. balance of payments problem had increased those risks. He therefore would vote for a policy of no change and alternative A of the draft directives.

Mr. Kimbrel remarked that Southerners seldom had to admit that their economy was not doing as well as the nation's. Generally, the South's long-term growth trend pushed area rates of expansion above the national average and overrode slight declines. Nevertheless, if the statistics were to be believed, some signs of local weakness could be seen that were not apparent in the national figures.

Mr. Kimbrel noted that total nonfarm employment in the Sixth District--measured on a seasonally adjusted basis--had trended slightly downward in recent months, with some weakness apparent in each of the Sixth District States, whereas nonfarm employment had continued to push upward for the country as a whole. District construction employment had declined more severely than elsewhere; manufacturing payrolls had weakened; average weekly hours of manufacturing were off more than the nation's; and the unemployment rate was slightly higher. Those declines, of course, were minor although most of them began two or three months ago. In addition, there were sectors of the economy that were still expanding. It could not, of course, be concluded from what had happened so far that the District's economy had started on a downhill course and that the nation's would ultimately follow. Nevertheless, those trends were slightly encouraging as evidence of some tendency toward a slower pace of economic growth.

Loans at the large District member banks had apparently declined in July according to preliminary seasonally adjusted figures, Mr. Kimbrel continued. That trend was still evident after account had been taken of the effect of loans sold outright and under repurchase agreement by the large banks. During the past two weeks those operations had apparently been curtailed by the relatively few large commercial banks that had been actively seeking nondeposit sources of funds.

Mr. Kimbrel added that he would have been more encouraged by those trends had he not just talked with the industrialists whose firms were surveyed about their authorizations or appropriations for new capital expenditures. After adding up the reported figures, the Atlanta Bank discovered that the firms seemed to have raised instead of reduced their plans for capital expenditures. It had been pointed out to him that most of the firms he had contacted were public utilities, which were the least likely type of business to cut back on capital spending and thus might not be representative of firms generally.

However, Mr. Kimbrel said, recent conversations with top executives of the largest banks in Atlanta suggested that they knew of practically no reductions in plans for capital expenditures in the Atlanta area. No one, they reported, except those on the bottom margin whose projects were of minor size seemed to be finding that the cost and availability of funds were limiting their projects. Some bankers suggested that a more effective way to limit capital expansion would be for the Administration to appeal directly to the major corporations. In general, residential builders with the exception of a few speculative builders of residences were not being limited; the problem of rising construction costs seemed to pinch them more than the availability of funds. The Atlanta bankers had cited two examples of major construction projects in Atlanta that were being financed at least temporarily by the firms using their lines of credit for the first time in years. Those firms had established their relationships over the years and had been extremely good customers of the banks.

One of the bankers reported that last year only 17 per cent of the lines of credit were being used, Mr. Kimbrel continued. This year 54 per cent of the lines were being utilized. The Atlanta bankers had failed to detect the slackening in loan demand suggested by the statistics collected from them and adjusted for seasonal change. They still felt that demand for inventory loans was strong and borrowers were more worried about rising costs than the high cost of funds.

Mr. Kimbrel said he had been interested to learn from the bankers that, although most of them had deeply resented the Board's letter of September 1966,[1] they would now be happier if something of that sort had been issued several months ago. That would, they believed, have enabled them to have limited their loan expansion more easily. In that connection, he had been interested to receive a letter from a banker at one of the largest banks in Alabama stating that the bank's executive committee was reviewing all loans with the hope of reducing outstandings and would like to have any guidelines that might have been issued by the Federal Reserve.

Mr. Kimbrel indicated he had not been surprised to learn that District bankers favored raising the Regulation Q ceilings on large-denomination CD's. One of the large banks in Atlanta reported that one day last week eighty customers had asked how they might reinvest funds deposited in the bank in Treasury

[1] Letter of September 1, 1966, sent over the signature of the Presidents of the Federal Reserve Banks to all member banks expressing System views on bank credit expansion, notably the need for a slower rate of expansion of bank loans to business, and on the use of Reserve Bank discount facilities.

bills, Federal agency issues, and other higher yielding short-term securities. The bankers stated they believed that with such a larger percentage of funds outside the control of bankers the System had far less control than formerly.

Mr. Kimbrel said he was passing on the results of those conversations with Sixth District bankers not so much because their current assessment might be correct but because he thought it reflected the continued impact of inflationary expectations. So long as those expectations persisted, the Committee would have to keep a tight rein. The difficulty, as the discussion this morning had indicated, was that it was not too easy to identify just which tight rein the System ought to be using. There seemed to be a remarkable lack of co-ordination between the behavior of short-term rates and the aggregate measures of reserves, bank credit, and the money supply. There seemed to be a danger that, if the Committee sought solely to maintain relatively high rates without being guided to a considerable extent by the availability of member bank reserves, it might inadvertently be tightening the reins rather than keeping them tight. However, he did not believe circumstances argued favorably for a rise in the discount rate. Nevertheless, he shared the view that the System might be approaching the appropriate time when some latitude under Regulation Q would be needed for very large or longer-maturity CD's.

With continued inflationary pressures, Mr. Kimbrel said, he hoped that the Committee would not go on record as moving toward a less restrictive policy. However, he would not be averse to allowing rates to move down a bit if that was the only way by which the reserve aggregate and monetary variables could be prevented from continuing the downward trend that was projected for August.

His preference for the directive, Mr. Kimbrel concluded, would be alternative A; he would grant the Manager generous flexibility to accomplish essentially the firm conditions prevailing since the Committee's last meeting.

Mr. Francis observed that at the previous meeting of the Committee, and again today, some participants had discussed the difficulty of assessing the degree of tightness of monetary actions as indicated by money market conditions. It had been pointed out that the same degree of restraint might be consistent with lower interest rates if demands for credit eased in coming months. He did not intend to repeat the analysis, but it appeared that developments in money and short-term credit markets in recent weeks, and the prospects for August summarized in the blue book, made that possibility more imminent. Furthermore, the redefinition of deposits, at least since last December as discussed in the blue book, increased the uncertainties concerning the degree of monetary restraint indicated by the growth of monetary aggregates. Before its redefinition money had been increasing at a 2.4 per cent rate since December and was almost unchanged since April. The redefinition of the money stock had increased its growth rate to 4 per cent since December and to almost 5 per cent since March.

At first glance there might be some tendency to view the new figures with alarm and to argue that a greater degree of restraint should be sought, Mr. Francis said. However, he did not believe that conclusion was valid. It had been known for some time that the seasonal adjustment of the published money stock data was due for a major revision, and that possibly by the next meeting of the Committee there would be another new set of data. The staff at the St. Louis Bank had computed a new seasonal for money for internal purposes which indicated that the published money stock series overstated the growth of money since December by a significant amount. Similarly, the recent growth of money after redefinition of deposits might be overstated in the blue book. Indications were that when the new seasonal adjustment was available, money might show a rate of increase of about 2.5 to 3 per cent from December to July, even after taking into account the redefinition of deposits. The growth of the monetary base so far this year tended to support those estimates of moderate growth in money.

Mr. Francis observed that the effects of monetary actions influenced economic activity with a lag, distributed over time. Evidence was now developing that total spending was beginning to moderate. For example, business loans at large commercial banks had shown little net change in the last nine weeks, after rising at a 13 per cent rate earlier this year. It was unlikely that that new trend reflected merely the disintermediation of bank deposits caused by Regulation Q, since in recent weeks both short- and long-term interest rates had tended to ease. For instance, dealers had marked down rates on commercial paper from 8-3/4 to 8-3/8 per cent.

With demands for credit beginning to weaken, Mr. Francis said, money market conditions were a poorer guide than usual for the System to use in its weekly operations. If the Committee continued a "no change" policy with the intention of "maintaining the prevailing firm conditions in money and short-term credit markets," as outlined in alternative A, or if it permitted only a slight easing of the restraint in those markets over the next several months, the probabilities were great that the contraction in key monetary aggregates would continue and even accelerate, and monetary actions would become unduly restrictive. Therefore, it seemed to him that adoption of alternative B at this time was essential if the Committee was to avoid mistakes of the kind it had acknowledged in the past.

Mr. Francis suggested that over the next several months System actions be conducted so as to provide for a 2 to 3 per cent annual rate of increase in money and the monetary base. He felt it was essential to avoid a prolonged decline in the money stock of the magnitude projected for August. With regard to total member bank reserves, the System might seek to keep reserves about unchanged since banks required somewhat fewer reserves as long as Regulation Q was still causing a marked decline in outstanding CD's. However, once banks could effectively compete for time deposits, then total reserves might be expanded at a 3 or 4 per cent rate. Providing for moderate growth in monetary aggregates would probably foster some decline in market interest rates and some easing in other money market conditions. The exact amount of easing would depend on how rapidly demands for credit declined. The Committee should not attempt to prevent that retreat of money market pressures or interpret them as a shift in policy.

Mr. Robertson made the following statement:

> The combination of our open market operations and regulatory decisions are now biting hard enough to give us some real financial restraint--regardless of what particular set of measures you look at. In fact, some indicators may have gotten even tighter than members of the Committee anticipated.
>
> There have been two developments outside the credit sphere that argue against further tightening of monetary pressure. One is the passage of the surtax, which should assure the maintenance of firm

fiscal restraint, at least for the rest of this calendar year. The other is the devaluation of the French franc, the repercussions of which are still in train. We can be glad the exchange rate changes and immediate market reactions were no greater than they were. But I expect the French action has stirred up uncertainties as to exchange rates and international money flows that can make our money markets a bit edgy and those banks which are borrowing heavily in the Euro-dollar market a little more cautious.

At the same time, I think the over-all state of the economy calls for about the kind of over-all credit restraint we now have in place. The economy, although expanding somewhat less rapidly than before, is still moving ahead briskly enough to carry additional wage and price increases with it. Our biggest economic problem continues to be the inflationary psychology that has been deeply embedded in our system. We are finally beginning to make headway on this front, but I feel sure that an obvious action to relax monetary pressure would run the risk of throwing new fuel on the fire of inflationary expectations. We face the handicap of having an easing action interpreted as the beginning of a repetition of the monetary history of the second half of 1968, with all the stimulus to inflation which that implies. It would be particularly unfortunate if we took action that stirred such a public reaction just now, for it could appear once again to be offsetting some of the needed restraining effect of the surtax. On the other hand, we must not be so fearful of being misinterpreted as to cause us to delay taking the right action at the right time.

As of this moment, it is my belief that (1) the uncertainties stirred up by the foreign situation are enough to argue that the Managers should be given more than the usual degree of flexibility to adjust their operations to events; and (2) that we should endeavor to hold to the existing degree of restraint but to prevent additional tightening by directing the Trading Desk to resolve doubts on the side of ease.

In order to avoid any inadvertent tightening of monetary policy by holding conditions in money and short-term credit markets firm even in the face of money easing resulting from a diminution of credit demands, I would suggest that the second paragraph of the directive be revised to read as follows:

> "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in money and short-term credit markets while endeavoring to moderate further contraction in monetary aggregates; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if pressures arise in connection with foreign exchange developments."

Mr. Robertson added that his proposed directive would avoid giving complete emphasis to money market conditions at the possible expense of inadvertent further contraction in the monetary aggregates. He thought such a directive would give the Manager sufficient leeway to make any needed adjustment in a gradual manner on the side of ease. He agreed with Mr. Swan on the desirability of rephrasing the reference in the first paragraph to the balance of payments on the official settlements basis.

Chairman Martin commented that like Mr. Galusha he feared the "ides" of August. He had reread with considerable care the Committee's records since last August and had come to the conclusion that the System had been misled into premature easing in 1968 by an overemphasis on technical considerations at the expense of proper attention to the psychological environment. Too much emphasis was placed on the prospective $25 billion turnaround in the fiscal position of the Federal Government and not enough on the underlying inflationary expectations which had been building up over an extended period. The mistake had subsequently been compounded for a period of several months by the rationalization that some moderation of the inflationary pressures was imminent. In December, of course, the Committee had reversed itself, and he felt that the Committee's policy since then had been quite appropriate.

Today, the Chairman continued, he was firmly on the side of those who were opposed to any further restraint. On the other hand, given the prevailing inflationary climate, he did not favor a directive calling for an overt move in the direction of ease. He thought Mr. Francis had pointed up the issues well, although he did not subscribe to Mr. Francis' monetarist approach, he (Chairman Martin) did not think the Committee could ignore the forces of psychology. In particular, he felt it was important for the System not to get into a position of validating the expectations of numerous skeptics who believed the System would ease its policy as soon as it heard the words "recession" or "overkill." Illustrative of that attitude were comments he had heard a major corporate executive make at a recent business conference. No one wanted a recession, but at the moment he (the Chairman) felt the main danger was from a new outburst of inflationary sentiment which could be generated if it became apparent that the Administration and the Federal Reserve had begun to implement easing policies.

Chairman Martin said he could endorse the staff's economic projections in the sense that they expressed the objective of

System policy in recent months. That policy had involved a difficult balancing act which he believed had a chance of succeeding, although there could be no certainty about that outcome. This was a critical and difficult period and, as always, timing was the key issue. He believed the need for some overt action might well arise over the next three months. It would be desirable for any such move to be made in an orderly and gradual way, but that might not be possible because the System had lost some of its flexibility in the current environment. Adding to the System's difficulties were the possible repercussions of the French devaluation on foreign exchange markets.

The Chairman observed that the consensus of the Committee seemed to be in favor of alternative A, subject to the understanding that the Manager would resist the development of undue tautness. Alternative A interpreted in that manner was also his own preference. Mr. Robertson had suggested that any doubts be resolved on the side of ease, but he (Chairman Martin) would be apprehensive about using the term "ease" in reference to the present directive. He did not agree with the sort of directive favored by Messrs. Mitchell and Maisel.

Mr. Hayes commented that Mr. Mitchell's proposed rewording of the second paragraph of the direcitve seemed to involve too basic a change to permit the directive to be interpreted as a "no change" policy. Mr. Robertson's version appeared to be closer to alternative A, which he favored, but that directive too would introduce a basic modification by calling for new language concerning the moderation of contractive tendencies in the monetary aggregates. He (Mr. Hayes) wondered if the Committee's concern was not related essentially to the possibility of increased pressures stemming from the Board's new regulations designed to close various loopholes. If the Committee wanted to instruct the Manager to resist such pressures, he thought the best procedure would be to add a clause to the proviso which might read: "or if pressures arise in connection with regulatory changes affecting bank reserve requirements."

Mr. Daane said his preference for the directive would be alternative A as drafted by the staff with the understanding Chairman Martin had outlined concerning the avoidance of undue pressures. He would be wary of any directive which might be interpreted as a move toward ease. For that reason, he would not be in favor of Mr. Robertson's proposed directive calling for the moderation of further contraction in the monetary aggregates. In his view such a directive would be quite close to the version preferred by Messrs. Mitchell and Maisel.

Mr. Swan noted that if the Committee adopted alternative A with the understanding concerning the need to avoid undue pressures, there would remain a question about the interpretation of such a directive in the event that some easing developed from market forces. Would the Manager feel he had to offset such easing in order to maintain "prevailing firm conditions" in the markets?

Mr. Sternlight replied that if such easing developed from within the market, alternative A could be interpreted to allow some of the reduced market pressures to show through; that is, the easing tendency would not be offset in any mechanical way. Of course, any easing tendency would be offset to a greater extent under alternative A than under alternative B.

Messrs. Daane and Sherrill expressed their agreement with Mr. Sternlight's interpretation. Mr. Sherrill added that otherwise the Desk would in effect have to tighten policy in order to maintain prevailing market conditions in the face of an easing in market pressures.

Mr. Hayes observed that the Desk would have to exercise caution in such circumstances so as not to respond too sympathetically to every temporary swing in market psychology.

Mr. Maisel commented that if there was no change in the way the Manager was moving--if he continued to operate the way he had been with respect to money market conditions--then clearly the probabilities were high that further tightening would occur.

That had been the experience of the past two or three months. It was true that the Federal funds rate and certain other market rates had fallen, but there certainly had been steady tightening in terms of the monetary aggregates and the amount of reserves furnished. The tightening trend was also illustrated by the fact that the staff had continued to fall short in its estimates of the amounts of decline. In short, the Committee's directive had resulted in steady tightening day by day. Alternative A in his view could not be interpreted in any way except as a further tightening directive.

Mr. Hayes indicated that he wanted to register a strong dissent from Mr. Maisel's view that steady tightening had been involved in the implementation of the directive over recent months.

Mr. Mitchell said he wanted to reiterate his view that the substitution of a reference to "monetary aggregates" for the present reference to bank credit in the second paragraph of the directive would be a highly desirable change. Problems encountered in measuring bank credit had discredited that aggregate as a workable instruction to the Manager.

Mr. Hayes conceded that available measures of bank credit were defective, but he also believed that Mr. Mitchell's alternative would risk conveying the notion that the Committee had become enamoured of the monetarist approach to policy. He would have less objection, perhaps, to references to both bank credit and money in the proviso clause.

Mr. Mitchell said that the addition of a reference to money would be an improvement in his opinion.

Mr. Hickman suggested that a possible alternative would be to state the proviso in terms of reserves and the monetary aggregates.

Mr. Brimmer said he continued to prefer alternative A as drafted by the staff. He did not think the suggested changes should be made in the proviso clause because, as he had observed earlier, he did not believe the Committee should alter its operating techniques at this time.

In the discussion which followed, various suggestions were made concerning the possible incorporation of a reference in the directive to the Board's new regulatory measures. Mr. Holland indicated that it would be technically accurate to add to the proviso the language "or with bank regulatory changes" if the Committee wanted to include such a reference in the directive.

Mr. Brimmer observed that he would resist any notion that the new regulations might provide an excuse for easing policy.

Mr. Robertson said he felt there was a general understanding among the members that the new regulations were not designed as tightening measures. Chairman Martin expressed his agreement with that appraisal.

Mr. Mitchell said the new regulations might nevertheless tend to have a tightening influence in terms of market psychology but he was not sure.

Mr. Sternlight indicated that such a market reaction was possible and in that event it might be necessary to allow some of the monetary measures to be on the easier side of their indicated ranges.

In response to questions about the staff draft of the statement concerning the U.S. balance of payments on the official settlements basis, Mr. Solomon indicated that the information available for July was still highly tentative and the statement had been worded with that fact in mind.

In the course of further discussion concerning the language of the directive, Mr. Holland noted that the earlier suggestions by Messrs. Hayes and Coldwell relating to the statement about economic prospects might be accommodated by substituting the words "and some further moderation is projected" for the present draft language reading "and prospects are for further moderation in the period ahead."

Chairman Martin then proposed that the Committee vote on alternative A of the draft directives, incorporating the changes suggested by Mr. Holland in the first and second paragraphs and also the change in the statement on interest rates suggested by Mr. Hayes.

With Messrs. Maisel and Mitchell 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 indicates that expansion in real economic activity slowed somewhat in the first half of 1969 and some further moderation is projected. Substantial upward pressures on prices and costs are persisting. Most market interest rates recently have receded slightly from their earlier highs. In July the money supply expanded as U.S. Government deposits decreased further; bank credit declined on average, after adjusting for an increase in assets sold to affiliates and to customers with bank guarantees. The run-off of large-denomination CD's which began in mid-December continued without abatement in July, and there apparently were net outflows from consumer-type time and savings accounts at banks and nonbank thrift institutions combined. The over-all balance of payments deficit on the liquidity basis remained very large in July; the balance on the official settlements basis was still in surplus in the first half of the month but subsequently shifted toward deficit as U.S. banks' borrowings of Euro-dollars leveled off. Foreign exchange markets appear initially to be adjusting in an orderly fashion to the announced devaluation of the French franc. 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 sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

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

Chairman Martin proposed that the Committee postpone its consideration of possible outright System transactions in Federal agency obligations until the next meeting, on September 9. He noted that he had been discussing the question with a number of persons and that he continued to have reservations about such operations. He felt they were largely a political issue at this time.

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

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

August 11, 1969

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on August 12, 1969

FIRST PARAGRAPH

The information reviewed at this meeting indicates that expansion in real economic activity slowed somewhat in the first half of 1969 and that prospects are for further moderation in the period ahead. Substantial upward pressures on prices and costs are persisting. Most market interest rates recently have receded from their earlier highs. In July the money supply expanded as U.S. Government deposits decreased further; bank credit declined on average, after adjusting for an increase in assets sold to affiliates and to customers with bank guarantees. The run-off of large-denomination CD's which began in mid-December continued without abatement in July, and there apparently were net outflows from consumer-type time and savings accounts at banks and nonbank thrift institutions combined. The over-all balance of payments deficit on the liquidity basis remained very large in July; the balance on the official settlements basis was still in surplus in the first half of the month but subsequently shifted toward deficit as U.S. banks' borrowings of Euro-dollars leveled off. Foreign exchange markets appear initially to be adjusting in an orderly fashion to the announced devaluation of the French franc. 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 sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions 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 pressures arise in connection with foreign exchange developments.

Alternative B

To implement this policy, and in the interest of moderating contractive tendencies in monetary aggregates while maintaining a position of firm over-all credit restraint, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving slightly less restrictive conditions 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 pressures arise in connection with foreign exchange developments.