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, October 7, 1969, at 9:30 a.m.

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

Messrs. Francis, Heflin, Hickman,[1] and Swan, Alternate Members of the Federal Open Market Committee

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

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

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

1/ Entered the meeting at point indicated.

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. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Parthemos, Jones, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Richmond, St. Louis, and San Francisco, respectively
Messrs. Hocter and Brandt, Vice Presidents of the Federal Reserve Banks of Cleveland and Atlanta, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Bodner, Assistant Vice President, Federal Reserve Bank of New York
Mr. Davis, Adviser, Federal Reserve Bank of New York
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 September 9, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on September 9, 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 September 9 through October 1, 1969, and a supplemental report covering the period October 2 through 6, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said that official gold transactions continued to be very minor and the Exchange Stabilization Fund's gold holdings remained at about the level of recent months. There had, of course, been no change in the official gold stock. The private gold markets also had been generally quiet. South Africa evidently had continued to be a regular seller and the price had stayed below $41.00, reaching a low of $40.62-1/2 last Monday (September 29) at the time the annual meetings of the International Monetary Fund and World Bank opened. Those meetings produced a brief flurry in the market but the price had again receded. The continued calm in the gold market during a period of intense activity in the exchange markets certainly had been welcome. Nevertheless, it was clear that there was substantial continuing demand for gold when the price remained just below $41.00 despite the persistent South African sales and the continued existence of the overhang of official sales of 1968.

Mr. Bodner commented that the exchange markets were now passing through a period of experimentation and uncertainty. After taking in about $1.5 billion in the weeks immediately prior to the elections, the German authorities had closed the market to avoid an even more massive inflow in the final two pre-election days. That move had come as a relief to the market, but had left open the question of what was to be done after the elections. As the Committee was aware, after a brief fling at reopening for business as usual, the German Government decided temporarily to abandon any attempt to maintain the mark limits and, in effect, to let the rate float. The mark already had been trading above the ceiling in the absence of official intervention prior to the weekend, but the official confirmation that it was to be let free for some time--and the clear implication that that temporary period would be followed by the introduction of a new parity--set off a further sharp rise in the rate.

Over the past week the mark had moved fairly steadily upward to its present level, some 6-1/4 per cent above par, Mr. Bodner observed. There was a widespread feeling in the market that a new parity would be set at approximately that level and the German Federal Bank seemed to share that view. The German authorities had not completely withdrawn from the market; in fact, they had been selling dollars each day as the rate moved higher, to keep it from falling back. That, too, had encouraged the market's belief that the new parity would be set at something approximating the current level. In a statement yesterday Mr. Schiller made an apparently firm commitment that the matter of the mark parity would be the first order of business of the new government.

The German move had taken the heat off the Belgian franc, Mr. Bodner continued. It had also completely reversed the situation in the Dutch guilder market; the guilder rate was now close to its ceiling and the Dutch had taken in sufficient dollars in recent days to repay completely the $109.7 million in outstanding swap drawings from the System. On the other hand, the French franc and the Italian lira had remained under pressure and the central banks of both countries had suffered steady reserve losses. Moreover, rumors were now beginning to be heard in the market that, following the German precedent, the French franc would be allowed to float. The lira had been at its floor throughout September and the beginning of October, and the Italian authorities had had to take several steps to bolster their reserve position. Those steps included drawing $300 million on the swap arrangement with the System and encashing $187 million in Export-Import Bank paper. With continued political and labor uncertainties in Italy, the situation there remained serious. During last week's Fund and Bank meetings, Dr. Carli had indicated that he might well have to make additional drawings on the swap facility. French reserve losses had not been so large as those of Italy but they were a cause of considerable concern, coming as they did after devaluation. As the Committee members might have noted, a French official had stated a few days ago that French reserves were now back to their pre-devaluation level.

Through all the turmoil in exchange markets in September, Mr. Bodner observed, sterling had held up very well and the British had been able to take in small amounts of dollars fairly regularly. The release of good balance of payments figures for the first half of the year, and exceptionally good trade figures for August, gave sterling sufficient muscle to ride through the mark speculation in mid-September. The sharp rise in the mark rate since it was set free had, of course, further strengthened sterling. At the month-end the British were able to repay $25 million on the swap arrangement, thereby reducing their drawings to $1,100 million. With just a few good figures and with still-massive short- and medium-term debt, the British were certainly not out of the woods. But there was no doubt that the market atmosphere--especially in London--was very much more relaxed and confident than it had been for some time. That had been reflected in the attitude of almost all the British officials and private citizens he had talked with at the Bank and Fund meetings.

Mr. Bodner remarked that the Swiss franc generally had been on the sidelines through September. Toward month-end, however, there had been a substantial flow into the Swiss National Bank, mainly because of end-of-quarter liquidity requirements. The Swiss had made $150 million of the inflow available to the Bank for International Settlements for lending to a Common Market country and had obtained forward cover from the BIS. That still left them with approximately

$150 million in excess of their usual dollar position, but so far the National Bank had not requested a swap drawing by the System. That possibility remained open, however, depending in part on developments during the remainder of October. Meanwhile, given the current uncertainties, the Swiss franc had remained strong and was holding just below its ceiling without the usual reflux of funds after the quarter-end. Indeed, the Swiss Government had felt called upon to deny that it had any thought of revaluing the franc.

Finally, Mr. Bodner said, he might comment briefly on the current status of the discussion of exchange rate flexibility. The German move, coming during the Fund and Bank meetings, evidently seemed to some observers to be a sign of things to come in international monetary arrangements. He thought, however, that it constituted a very special case that would prove of limited utility as an experiment with exchange rate flexibility. That seemed, moreover, to be the predominant opinion among those attending the meetings, and most of the central bank Governors and Finance Ministers who spoke on the question had taken a very cautious approach.

Secretary Kennedy's statement perhaps best encompassed those views, Mr. Bodner remarked. The Secretary had noted that "In the first place, the various plans for 'limited flexibility' in exchange rates seem to pose formidable technical and policy problems that will require careful study over a considerable period by national authorities, as well as international monetary bodies, before any consensus is possible." He had also said that "Given the pivotal role of the dollar in the international monetary system, the initiative for even limited exchange rate adjustments would continue to lie with countries other than the United States." The Secretary had concluded that "It is implicit in these comments that we believe that proposals for limited flexibility in rates offer no panacea for present problems," and that "As I have noted, these devices have had no official sanction and are full of subtle and unsettled technical and policy questions. In sum, they are a long way from fruition, if, indeed, some variant proves practical at all in the end. But neither are these ideas something that we can, or will, responsibly ignore."

As the members knew, Mr. Bodner said, it was generally agreed that those problems would best be left for further study in the IMF.

Mr. Mitchell referred to Mr. Bodner's comments on the recent swap drawing by the Bank of Italy. Noting that the Italians held a substantial volume of U.S. Treasury securities denominated in lire, he asked why they had not encashed those securities before drawing on the swap line.

Mr. Bodner replied that no dollars would have accrued to the Bank of Italy if it had encashed those securities. That was because the U.S. Treasury held about $134 million of lire, which was more than enough to cover the $125 million lire-denominated security outstanding.

Mr. Brimmer asked whether the Italians did not also hold dollar-denominated assets which they might be liquidating in coming months.

Mr. Bodner replied that the Government of Italy held $140 million of medium-term U.S. securities denominated in dollars, of which $85 million had been issued under a military offset agreement. In addition, the U.S. Treasury had technical forward commitments in lire to the Italian Exchange Office now totaling $1,291 million. Those forward commitments had been reduced by $377 million at the end of September, and similar amounts would be unwound at the end of October and November.

Mr. Maisel then raised certain technical questions about the cost and the rationale of the Treasury's forward commitments in lire. After discussion the Chairman remarked that in view of the complexity of subject it would be desirable to have it reviewed in a memorandum from the staff.

> By unanimous vote, the System open market transactions in foreign currencies during the period September 9 through October 6, 1969, were approved, ratified, and confirmed.

Mr. Bodner then noted that a memorandum from Mr. Coombs had been distributed this morning regarding possible increases in the swap arrangements with Austria, Denmark and Norway.[1/] As indicated in the memorandum, Dr. Kloss, General Manager of the Austrian National Bank, had approached him (Mr. Bodner) on Wednesday (October 1) at the Fund and Bank meetings to request an increase in the swap facility of $100 million to bring it up to $200 million. Dr. Kloss had said that the Austrians had suffered relatively large reserve losses recently and were concerned about possible further losses in view of the high Euro-dollar rates and continued uncertainty regarding the mark. He had indicated that although Austrian reserves were fairly comfortable, there was some concern in the country and he thought that a swap line increase would have a very useful effect on the market. He also had indicated that Austria would ask the U.S. Treasury to repay the Austrian schilling-denominated Treasury note for $25 million equivalent--and that was done yesterday. Finally, he had reviewed with him (Mr. Bodner) the Treasury's procedures for gold sales, having in mind the possible need to sell gold temporarily to finance some swings in Austrian payments.

Mr. Bodner said that when he had reported the conversation to Mr. Coombs, who had returned to New York, the latter had raised the possibility that an increase in the Austrian line might be

1/ A copy of this memorandum, which was dated October 6, 1969, and entitled "Possible increases in swap arrangements with Austria, Denmark, and Norway," has been placed in the Committee's files.

followed by a request by the Danes and Norwegians for increases in their facilities, which also stood at $100 million. It seemed to Mr Coombs that if that were to be the case, it might be preferable to ask the Committee to consider simultaneously increasing all three lines rather than acting on a piecemeal basis. Mr. Coombs had asked Mr. Bodner to discuss the question with Mr. Hayes, who was attending the Bank and Fund meetings. Mr. Hayes had agreed with the proposed approach and had discussed it with Chairman Martin and Mr. Daane, who were also present.

Subsequently, Mr. Bodner observed, Chairman Martin had spoken with Governor Hoffmeyer of the Danish National Bank and Mr Hayes with Governor Brofoss of the Bank of Norway. Both Governors had indicated that they would favor such an increase in their facilities. As the Committee was aware, the Danish swap line had been fully utilized in the spring, and at that time the Treasury had made available another $50 million line. The use of a temporary U.S. Treasury facility had been chosen then because of the need for immediate action and because it was felt that to follow the System's procedure of announcing an increase would not have been desirable at the time. The Treasury facility had never been drawn upon and remained available to the Danes. It was contemplated, however, that the Treasury facility would be terminated if the Committee approved an increase in the swap line with the Danish National Bank. The Treasury had been kept informed of the discussions and had no objection to the proposal.

Chairman Martin remarked that he had discussed the proposed swap line increase with Governor Schmitz of the Austrian National Bank, who had expressed concern about the outlook for the Austrian reserve position. While he (Chairman Martin) was doubtful that the Austrians would need to use the enlarged line, he thought it would be in order for the Committee to approve the increase. It also seemed reasonable to increase the Danish and Norwegian lines at the same time. Since the matter was being raised today without advance notice the Committee might prefer to postpone a decision. On the other hand, if the members saw no objection it might be desirable to act now.

Mr. Daane said that while it would have been desirable for the Committee to have had more time to study the matter, the case for the three swap line increases seemed to him to be clear-cut. Given the current state of uneasiness in exchange markets, he would favor approving the increases today. He noted from Mr. Bodner's comments that the Treasury was aware of the proposed arrangement, including the plan to terminate the temporary facility the Treasury had extended to the Danes.

Mr. Hayes said he might add that, as noted in Mr. Coombs' memorandum, all three of the countries involved were basically in a sound financial position. Austria had large reserves and its underlying balance of payments position was good. Even Denmark, which had suffered rather severe reserve drains earlier this year because of the mark speculation and the pull of the Euro-dollar market, was in a relatively good situation. In his judgment that provided the needed confidence for approving the swap line increases. He agreed that it was unusual for a proposal for action to come to the Committee with so little advance notice, but he thought action would be warranted in this instance. Having the increases put into effect promptly would be very much appreciated by the other parties, particularly the Austrians.

In reply to a question by Mr. Mitchell, Mr. Solomon said the Board's Division of International Finance saw no reason for not going ahead with the suggested increases.

Mr. Brimmer said he would not object to the proposed action but he was curious as to why the Austrians felt they needed a larger swap line. According to Mr. Coombs' memorandum they held nearly $1.5 billion of reserves, not counting their large creditor position with the IMF, and their basic payments position seemed to be strong. As to Norway and Denmark, the reserves of the former were down somewhat this year, but still at the high level of $650 million; and Norway also had a creditor position with the Fund. While Denmark's reserves had declined sharply this year, like the Norwegians the Danish officials had not found it necessary to initiate the proposal for a swap line increase; perhaps they had other resources. It was his recollection that the Danes had not appeared to be unduly concerned during the period in which they were losing reserves.

Reverting to the Austrian situation, Mr. Brimmer said he wanted to record the fact that he was reluctant to enlarge the credit facilities extended to a country with a strong balance of payments position and with large reserves for its modest size. He was curious about the rationale of the proposal that the System agree to a swap line increase. Was it advanced simply because the Austrians had requested such action? He gathered that there was some feeling in the System that they were not likely to need the increase.

Mr. Hayes remarked that he would defer to Mr. Bodner on the technical question of whether the Austrian swap line increase was likely to be needed. He would say, however, that Austria's strong reserve position did not appear to him to offer grounds for refusing to enlarge the swap line. Situations often arose in which a country with a strong reserve position had legitimate reasons to fear heavy drains.

Mr. Solomon commented that the Austrian situation was a classic example of the case for expanding world reserves by activating Special Drawing Rights. It appeared that, no matter how large the reserves of a country were, it would resist declines in them.

Mr. Bodner concurred in Mr. Solomon's observation. Despite the relatively large size of their reserves, he said, the Austrians were concerned about the possibility of drains and were convinced that an increase in their swap line would be wise. The Danes would have asked for an increase in their line earlier, at the time it was fully utilized, had not the temporary Treasury facility been made available to them. Since then their reserve position had improved, partly because they had floated a number of foreign bond issues. Nevertheless, they were delighted now at the prospect of an increase.

Mr. Daane said he agreed with Messrs. Solomon and Bodner. It seemed to him that the present situation was of a type the swap network had been intended to deal with. Although the three countries involved might have other resources for meeting reserve drains, the swap lines were useful adjuncts. He did not see how the proposed increases could be anything but helpful.

Mr. Maisel observed that from discussions with the Norwegians and Danes he understood that the authorities in both countries felt that the growth of the Euro-dollar market had tremendously increased the risks facing their currencies. That fact might justify use of the swap lines in situations where other reserve management techniques might have been appropriate before the Euro-dollar market has assumed its present importance.

In reply to a question by Mr. Sherrill, Mr. Solomon said that a revaluation of the German mark was not likely to increase the strain on Austrian reserves; it was probable that Austrian reserves would benefit, given the closeness of the trade relations between the two countries. A mark revaluation would put upward pressures on domestic prices in Austria, but the net balance of payments effects were likely to be favorable.

Chairman Martin said that, as he had indicated earlier, he questioned whether the Austrians would find it necessary to use the enlarged swap line. The fact remained, however, that they were sufficiently worried about the outlook to request the increase. Since one purpose of the swap network was to cope with the type of problem they thought they faced, he saw no reason for not acceding to their request.

Mr. Hickman entered the meeting at this point.

Mr. Coldwell said he was curious as to why the System had taken the initiative with respect to possible increases in the lines with the Danish and Norwegian central banks. Apparently, neither of those banks had been sufficiently concerned about the outlook for their currencies to propose such action themselves.

Chairman Martin commented that Mr. Coldwell's question was certainly a legitimate one; perhaps the System should not have taken that initiative. On the other hand, the Committee had always tried to keep a certain degree of balance in the relative sizes of its different lines. From the System's point of view there was no advantage in keeping the Danish and Norwegian lines at $100 million--the smallest in the whole network--if the Austrian line were to be increased to $200 million. The fact that the Danes had experienced difficulty earlier this year lent force to the argument that their line should be increased if Austria's was.

Mr. Daane added that, as Mr. Coombs' memorandum noted, the three countries had roughly equivalent status in international finance, as reflected in the close correspondence of their IMF quotas.

Mr. Hayes said it was important to keep in mind that the System's swap network had worked to the benefit of the United States on many occasions in the past. The increases in question--particularly that with the Austrians--might well do so in the future. The swap network was not a one-way street.

By unanimous vote, increases of $100 million each, from $100 million to $200 million, in the swap arrangements with the Austrian National Bank, the National Bank of Denmark, and the Bank of Norway, together with the conforming amendments to paragraph 2 of the Authorization for System foreign currency operations, were approved, effective immediately. As amended, the paragraph read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	200
National Bank of Belgium	500
Bank of Canada	1,000

Foreign bank	Amount of arrangement (millions of dollars equivalent)
National Bank of Denmark	200
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000
Bank of Italy	1,000
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	200
Bank of Sweden	250
Swiss National Bank	600
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

Chairman Martin said he might offer a word on the Bank and Fund meetings that were held in Washington last week. The meetings--the 24th of their type--were the most historic since Bretton Woods because of the vote to create SDR's. Other events were largely over-shadowed by the developments with respect to the German mark. It was his hope that the mark would be revalued in due course and that that would bring things back into focus.

The Ministers and Governors of the Group of Ten also met last week, Chairman Martin continued. Baron Snoy, the Belgian Finance Minister, was elected chairman to succeed Mr. Schiller, who had not come to Washington. The Governor of the Belgian central bank spoke at some length on how the Euro-dollar market affected domestic financial markets in Europe and on the threat it posed to stability in those markets. He (Chairman Martin) had made a few brief comments regarding the System's awareness of the problem and the difficulties it faced in connection with the Regulation Q ceilings. Because the System had imposed marginal reserve requirements on Euro-dollar borrowings of U.S. banks and because those borrowings had leveled off in recent weeks, there was no great pressure now for the System to take any particular action with respect to the Euro-dollar problem.

In a concluding remark, the Chairman said he thought Dr. Blessing had distinguished himself during the recent eventful period for the mark. He had spent several hours with Dr. Blessing on Sunday afternoon and evening, during which the latter reviewed the advice he was sending to his government regarding the alternatives it faced. It was his impression that Dr. Blessing had proved to be a tower of strength to his government without taking sides in the recent debates.

Chairman Martin then asked Mr. Solomon to comment on the recent meeting of Working Party Three which the latter had attended.

Mr. Solomon said that both Working Party Three and the Group of Ten Deputies had met in recent weeks. At a one-day meeting of the Deputies in Paris in mid-September, which Mr. Daane had attended, the French situation had been reviewed and approval had been given for use of the General Arrangements to Borrow in connection with France's drawing from the IMF. He believed that the review of French problems and policies left some doubts as to whether present domestic policies would be fully adequate to make the French devaluation a success.

On the Saturday before the Fund and Bank meetings (September 27), Mr. Solomon continued, Working Party Three met in Washington with only one item on its agenda: the economic situation in the United States. In fact, however, a good part of the meeting was devoted to the German exchange market situation. The Germans had closed their exchange markets on Thursday, and what would happen on Monday was not clear. Following a report from Otmar Emminger--the new Chairman of Working Party Three, who had flown over from Frankfurt for the one day--the representatives of the other EEC countries were particularly active in pressing the German authorities not to re-open the markets on a full-scale basis but rather to let the mark float up. Dr. Emminger had been prepared to carry that message back.

Mr. Solomon said the discussion of where the U.S. economy and its balance of payments were going revealed some doubts as to whether the slowdown in the rate of expansion was as great as was measured in the GNP accounts. Nevertheless, there was a general recognition that the fiscal and monetary measures were beginning to bite. No one suggested that the present policy stance was inadequate, although Dr. Emminger wondered whether the movement of the monetary aggregates was not giving an exaggerated notion of the tightness of U.S. monetary policy.

While the Euro-dollar flows were discussed at some length, Mr. Solomon observed, there was less dissatisfaction expressed on that matter than in the past, since U.S. banks had not been increasing their Euro-dollar liabilities in recent months. The unsatisfactory nature of the U.S. balance of payments was acknowledged but was treated lightly for several reasons. Those included the difficulty of measurement because of the circular flow of U.S. funds through the Euro-dollar market, the surplus on official settlements until recently, and perhaps a general feeling that the condition of the U.S. economy would be considerably clearer later in the autumn than it was at the time of the meeting.

Mr. Daane said he would add two footnotes to Mr. Solomon's remarks. First, the Group of Ten Deputies decided--and the Ministers and Governors later agreed--that it would be well for the study of exchange rate flexibility to be centered in the Fund, rather than to have the Group of Ten embark on a parallel study. It was understood that the Group of Ten would maintain a continuing interest in the subject and from time to time would consider the results to date of the Fund's work. Secondly, when questions were raised at the WP-3 meeting regarding the adequacy of French policies, the French representatives responded that if additional policy measures were needed main reliance would be placed on monetary policy.

Mr. Hayes said he understood that the BIS also would hold in abeyance, for the time being at least, its independent study of flexible exchange rates that had been discussed at Basle earlier.

Mr. Solomon then remarked that it might be useful for him to comment briefly on the attitudes of the under-developed countries toward the events at the Bank and Fund meetings. It was his impression that they left the meeting with something less than satisfaction. They had supported the SDR proposal but felt--rightly--that the lion's share would go to the developed countries. They were also concerned about the possibility that in any general increase of quotas their relative quotas and voting power might be reduced. While they were quite pleased with the initiative Mr. McNamara had taken to increase the lending activity of the World Bank, they were not satisfied with the volume of loans they were receiving, and they were unhappy about the interest rates charged on those loans. Few if any of them had any enthusiasm for the proposals for greater flexibility of exchange rates; in their view more flexible rates would simply add one new uncertainty to the many now facing them.

Mr. Heflin asked whether activation of SDR's would have any implications for British repayment of their swap debt to the System.

Mr. Solomon commented that Britain's reserves would of course be increased; in the initial allocation on January 1, 1970, they probably would receive an amount of SDR's in the neighborhood of \$300 million to \$400 million. However, that would not be enough to repay their debt to the System, which presently stood at \$1.1 billion. Moreover, for various reasons it was not likely that they would want to disburse all of their SDR allocation immediately.

Mr. Daane noted that under the Articles of Agreement SDR's were intended for use in financing balance of payments deficits and not for the purpose of changing the composition of reserves.

Mr. Daane then said he wanted to underscore the fact that at present no one could foresee all of the implications of the creation of SDR's. It was clear that they would add to world reserves and that they would not be used simply to change the composition of reserves. But looking down the road to, say, three years hence when \$9.5 billion of SDR's would be in place, it was not at all clear just how they would be used.

Chairman Martin commented that SDR's had been described as "fragile flowers." He hoped they would be permitted to grow and would not be overloaded in their early life with demands they could not be expected to meet.

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 September 9 through October 1, 1969, and a supplemental report covering the period October 2 through 6, 1969. Copies of both reports have been placed in the files of the Committee.

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

Yields on intermediate- and longer-term Government securities and on corporate issues moved sharply higher during the period since the Committee last met. Generally, the markets appeared to ignore any evidence of a slowing of the economy, focusing attention instead on the large volume of Treasury, corporate, and Federal agency issues coming to market against the background of the tight money position of most institutional investors. As the written reports indicate, yields on intermediate-term Government securities rose by 1/2 percentage point or more, while yields on long-term Government and corporate issues were up by 1/4 percentage point or more, before a rally developed over the past few days.

The rather erratic behavior of the long-term market recently reflects not only the pressure that underwriters have been under but also the market's sense of disappointment about the pace of progress in bringing an end to inflation. In this atmosphere the market has been highly concerned about the continuous pressure of Federal agency financing. The housing agencies alone have been raising about $1 billion a month in new money, and, as you know, the Federal National Mortgage Association had to offer an 8-3/4 per cent coupon on its latest 16-month issue. Large new money needs by FNMA and the Home Loan Banks are apt to keep the markets off balance in the weeks ahead. It should be noted that the municipal bond market has acted better over the recent interval as new issues continued to run at about half the normal volume and as hope grew in the market that the tax proposals affecting municipal securities would be watered down in Congress. The tax-exempt market, however, would have real difficulties--under current conditions--in coping with an expanded level of new issues.

Despite the erratic performance of the bond market, the Treasury's October financing was quite successful, with the public response more favorable than most market observers had anticipated. Attrition amounted to only $1.8 billion, less than expected, and the Treasury was able to achieve a significant amount of debt extension. Despite the attractive terms and the good public response, the new issues ran into heavy weather after the books were closed. By payment date all of the new issues had moved to a discount--almost a full point on the longer-term 7-1/2 per cent issue--as dealers, for one reason or another, tried aggressively to reduce their newly acquired positions.

In an effort to help stabilize the market the Treasury purchased a modest amount of intermediate-term coupon issues, and on October 1 the System purchased for regular delivery $128 million of notes and bonds, including $65 million of the three new issues. As you know, the market subsequently stabilized with all three of the new notes moving back to a premium over issue price by last Friday. Official purchases were a factor in the market improvement, but perhaps even more important was the attractive pricing--and quick sell-out--of the new FNMA issue, about which the market had--in retrospect--been unduly apprehensive. In general, dealers have made good progress in distributing the $945 million of new issues they acquired in the financing, although some securities were sold at substantial losses.

In contrast to the performance of the coupon market, Treasury bill rates were quite stable over the period, with some downward push evident late last week and again yesterday. In yesterday's weekly Treasury bill auction, average rates of 7.05 and 7.29 per cent were established for three- and six-month bills, respectively, down in each case by about 1/8 percentage point from the rates established in the auction just preceding the last meeting of the Committee. Heavy foreign central bank buying of bills--especially by Germany--was a major factor stabilizing bill rates, and the reinvestment demands generated by the Treasury's financing worked in the same direction. In addition, dealers--faced with high marginal borrowing costs--have been working with relatively light inventories.

At the moment, there is some apprehension over the potential impact on bill rates if Germany becomes a large seller of bills as a result of a reversal of speculative flows after a new parity is established for the mark. But neither that apprehension nor the Treasury's announcement of an auction tomorrow of $2 billion April tax-anticipation bills prevented rates from moving lower over the past several days. The Treasury, however, will have to come back to the market with additional tax bill sales--perhaps before the end of the month and again in November or early December. If Germany does indeed become a sizable seller of Treasury bills--as seems quite possible--Treasury bill rates could again be subjected to upward pressure.

Open market operations over the period had to contend with the very wide swing in reserve availability caused by the shortfall in the Treasury's cash position before the September tax date, the even keel aspects of the Treasury financing against an erratic market background, and the international uncertainties over the status of the German mark. As the written reports indicate, the shortfall in the Treasury's cash position provided on average about $1-1/2 billion in reserves in the September 10 and 17 statement weeks, with direct borrowing from the System reaching $1.1 billion on September 10. In the week of the 24th, on the other hand, rebuilding of the Treasury balance withdrew an average of $1.8 billion in reserves. Again the matched sale-purchase agreement--used in record volume--proved its usefulness in absorbing reserves for a temporary period.

A fair amount of flexibility was required over much of the period in order to avoid the impact of fairly erratic shifts in reserve availability and of foreign central bank operations on money market conditions during a period of Treasury financing. On several occasions during the period the System had to reverse the direction of operations on short notice in order to avoid undesirable side effects on the money and securities markets. The purchase of coupon issues last Wednesday fitted in well with reserve objectives and with the relative availability of coupon issues as compared with Treasury bills. At the same time, it contributed towards stabilizing the Government bond market at a time when such stabilization was badly needed.

Looking to the period ahead, the System should be a net supplier of reserves over the next three weeks. So far--apart from coupon purchases last Thursday--we have been temporizing by supplying those prospective reserve needs through the use of short-term repurchase agreements. The main purpose of this temporizing has been to await developments in Germany, so that if the German Federal Bank becomes a large seller of bills the System might be in a position to take on at least a portion of such sales. At the moment it appears that the German Federal Bank may in fact sell at least $200 million of bills in the next few days.

We should also be alert to any sharp shift in market sentiment, whether it should be for the better or the worse. On the potentially pessimistic side there are (1) the continued pressure of Agency financing, (2) a risk of an adverse market overreaction if the belief should develop that the Treasury's cash position is substantially weaker than was anticipated, (3) the continued pressure of tight money on financial institutions, and (4) the possibility of trouble developing in the commercial paper market, where the growth of financing has been almost phenomenal in the past year. On the other side there are (1) the possibility of a spreading conviction that the economy is in the process of slowing down, a conviction that could be encouraged by the most recent unemployment figures, and coupled with this (2) the possibility of a market overreaction to even a modest relaxing of monetary policy if that is what the Committee should decide today. International developments and possible Congressional action with respect to taxes and spending are unknown quantities that could shift the balance of forces in either direction. In any event, with the lessons of 1966 and 1968 behind us, it would seem desirable for the System to work against any excessively rapid movement of the markets--in either direction--until there is time to assess the factors underlying the movement.

One final matter involves the proposed amendment to paragraph 2 of the continuing authority directive contained in my memorandum circulated to the Committee yesterday.[1/] While the odds are probably against any need for the Treasury to borrow on October 13 when the Federal Reserve Bank of New York is closed, it would appear prudent to cover such a contingency now and in the future by authorizing other Reserve Banks to purchase special certificates from the Treasury whenever the New York Bank is closed. Under the amendment proposed, this would be done by adding the words "or, if the New York Reserve Bank is closed, any other Reserve Bank for its own account" before the parenthesis in that paragraph. If the Treasury does have to borrow on the 13th of this month, it would appear appropriate to designate the Richmond Bank--partly because of its past experience and its convenient access to the Treasury--to act in this capacity. If the Committee approves the amendment, we would plan to discuss the technical details of the operation with the Richmond Bank and the Treasury over the next few days. In any event, the total amount of such certificates that may be held by Reserve Banks after this meeting would revert to the $1 billion level that had prevailed prior to the temporary increase authorized at the last meeting of the Committee.

1/ A copy of this memorandum, dated October 6, 1969 and entitled "Proposed amendment to continuing authority directive," has been placed in the files of the Committee.

Messrs. Robertson and Daane indicated that in their view the amendment to paragraph 2 of the continuing authority directive proposed by Mr. Holmes would serve a useful purpose.

By unanimous vote, paragraph 2 of the continuing authority directive was amended to read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York, or, if the New York Reserve Bank is closed, any other Reserve Bank for its own account (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

Mr. Brimmer said it was his impression that the recent Desk purchases of Treasury coupon issues were prompted in large measure by problems stemming from the overhang of agency issues in the market. Over the past weekend several dealers with whom he had talked had expressed great concern about prospects of being overloaded with new agency issues and the possibility of having to dump such issues in the market. In separate conversations three dealers had indicated that they counted on the Desk to bail dealers out of such difficulties. They apparently believed the System had purchased coupon issues last week in order to reduce their heavy inventories. He (Mr. Brimmer) wondered what means were available to relieve market pressures, assuming the Desk did not intervene directly in the Federal agency market.

Mr. Holmes replied that a key problem with respect to new agency issues was that of proper pricing. Some weeks ago dealers had been disturbed when a FNMA offering had been priced very narrowly in relation to the outstanding market and, indeed, had moved to a discount. While the dealers had been able to sell the issue, they had sustained losses and had expressed some resentment about the pricing decision. Last week's offering had been priced more attractively and had sold out quickly. As a result, earlier concerns were somewhat relieved and the market atmosphere had improved a little, at least temporarily. The unusually large volume of new agency issues in prospect would continue to create difficult pricing problems under current market circumstances, but in his view the problems could be resolved.

Mr. Holmes added that the Desk's recent purchases of Treasury coupon issues had been undertaken at a time when the market was under considerable stress, partly because of the sizable overhang of Federal agency issues. He did not think the System's purchases were generally considered to have been designed to bail out the dealers. Indeed, the Desk had taken pains to avoid giving that impression. While dealers might sometimes hope for miracles, they were aware that the System had not had a policy of relieving them of unwanted inventories in the past and he doubted that they really believed such a policy would be followed in the period ahead.

Mr. Brimmer then asked whether the considerable growth in the number of banks selling commercial paper was giving rise to concern in the commercial paper market.

Mr. Holmes said he sensed that some apprehension was developing. It was not related directly to bank paper except in the sense that such paper was pre-empting a share of the market at the potential expense of low-rated industrial paper and was contributing to the escalation of yields. For example, in the recent past yields on three-month commercial paper had risen to a high of 9-1/4 per cent.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 9 through October 6, 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:

After having been removed from the domestic economic scene over the past several weeks, my overwhelming impression in returning to the fray is that a considerable body of evidence has accumulated pointing to developing weakness in the economy. Thus, I find that industrial production, after being revised down for July, has declined slightly in August and that the expectation is for no change, or another small decline, in September; that new orders and backlogs in durable goods manufacturing have declined, the latter for the second time in three months; that retail sales have continued exceptionally weak both absolutely and relative to income flows; and that growth in employment slowed markedly over the summer.

Somewhat paradoxically, third-quarter GNP is now thought to have increased by around $17 billion or more, but the small pickup from the second quarter is more than accounted for by increased inventory accumulation while the gain in private final sales narrowed considerably further. This pattern of GNP growth, of course, is basically a reflection of weakness. The housing outlook is, if anything, even more grim than it appeared a month ago, and the sharp decline in State-local security offerings suggests that any sizable pickup in capital spending projects in this area, for the time being, simply cannot be financed. Federal outlays should be moving moderately downward again, now that the pay raise is incorporated in current spending levels, and the growth in business capital expenditures still appears to be moderating, even though there may be a little more strength here than we had thought earlier.

Given all these considerations, it seems to me that the probabilities are very high for a substantially smaller GNP increase in the quarter now beginning. Expansion could be supported for a while yet by rapid inventory accumulation, but sooner or later there is almost bound to be an adjustment in inventory policies in response to the weakened pattern of final sales, leading to a period of still smaller growth in GNP. At present, the figures on inventory investment are somewhat ambiguous. The July book value increase in manufacturing and trade combined amounted to nearly $1.4 billion, but the partial and preliminary reports now available indicate that the August rise was a good deal smaller. More generally, the relationship between production and sales suggests that substantial inventory accumulation is taking place. In recent months inventory-to-sales ratios have risen and are about as high or higher than in late 1966--just prior to the 1967 inventory correction. The ratio of inventories to unfilled orders in the durable goods industries also has risen sharply over the summer to the highest level since mid-1964, suggesting the need for a downward correction in some of these lines.

Some adjustments in production are already in process, as indicated by the leveling off in the industrial production index since June. These adjustments as yet do not appear to have necessitated appreciable layoffs, since insured unemployment claims have remained relatively low. But the rise in total employment has slowed significantly this summer, reflecting declines in construction employment and much reduced growth in many other industries. And the sharp rise in the unemployment rate to 4 per cent in September, though probably exaggerating the actual short-run weakness, did include appreciable increases in unemployment of adult workers as well as teenagers. What seems indicated is a slowup in new hiring, with the possibility of outright layoffs still to come.

The rise in personal income was quite well sustained during the summer, despite slower employment growth, presumably reflecting higher wage rates and especially the Federal pay raise. But retail sales remained surprisingly sluggish, and consequently a sharp rise in the personal saving rate is indicated for the third quarter. The nonparallel performance of income and sales obviously raises the possibility of a resurgence in consumer spending in the months ahead. Indeed, we do expect some gain in the fourth quarter, though not of large proportions. First, income growth should slow as the weakness in employment becomes more pervasive and in the absence of a special sustaining factor like the Federal pay raise. Second, consumer buying psychology seems unusually adverse as indicated by the sharp drop since early this year in the Michigan Survey Research Center's index of consumer sentiment. All components of the index have declined, but the deterioration is most pronounced in concern about inflation, high interest rates, and tight money. Disposable incomes will be boosted appreciably in January by reduction--or termination--of the Federal income surtax, but the extent to which this carries through to consumption will depend importantly on other conditions at the time.

Altogether, there seems to me to be little upward momentum left in the economy. Housing is weak and will continue so for some time to come, retail sales are flat and consumers pessimistic, inventory investment is unsustainably high relative to final demands in at least some lines, public expenditures are being held in check by fiscal and monetary policies, and reduced growth in employment and production is an actuality. Plant and equipment expenditures are still rising, and are projected to continue a moderate uptrend, although planned increases have a way of fading when demand pressures slacken. Inflation is also continuing at a rapid rate, and strong upward pressures on prices seem bound to persist for some time as large wage increases are demanded and granted and as businesses strive to protect dwindling profit margins. Nevertheless, it seems to me that policy has now essentially accomplished its objective of cooling off the economy to a point where inflationary forces will face an increasingly hostile environment.

Accordingly, I believe that the Committee should now consider taking the first steps toward a posture that will be more sustainable for the longer run, by which I mean a policy that would encourage a resumption of moderate monetary expansion. Most monetary aggregates were substantially negative over the third quarter, and the projections for October show continued declines. At the same time, interest rates generally have risen sharply further and there are widespread indications that it has become progressively more difficult to obtain credit in many markets. This outcome of policy seems too harsh for the current economic environment as I see it, and could well risk an undue constriction in credit-financed demands in the period ahead. I doubt that a modest move now would fuel any significant resurgence in inflationary sentiment, since credit would not soon become sufficiently available to make much real difference in financing plans and since other factors bearing on psychology--such as diminished profits and slower income growth--are likely to become increasingly evident in the weeks and months ahead. Therefore, I would recommend the Committee's adoption of alternative B of the proposed directives.1/

Mr. Morris asked what rate of growth in total bank reserves the staff would envisage if the Committee adopted alternative B for the directive.

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

Mr Partee replied that bank reserves would probably be little affected in October if the Committee adopted alternative B rather than A, since the month was already well under way. A greater effect could be expected in November, but it was possible that reserves would not increase then even if alternative B were adopted today. First, the policy change implied by B was quite modest. Secondly, the relationship between somewhat lower market interest rates and existing Regulation Q ceilings would probably not encourage any greater increase in bank time deposits. Finally, it might well be that demand for money and bank credit was fading; if that were the case, it might prove difficult to achieve growth in the monetary aggregates over the months ahead. On balance, he could not say at this point whether the aggregates would be rising or declining in November.

Mr. Swan noted that the monetary aggregates were projected to weaken in October relative to September. He asked whether they would be expected to show less weakness in November if conditions in money and short-term credit markets remained unchanged, as called for by alternative A.

Mr. Keir replied that the staff had not yet made formal projections for November He would expect, however, that the monetary aggregates might show some improvement relative to October even if alternative A were adopted.

Mr. Maisel indicated that before today's meeting he had obtained from a member of the staff what might be called an "unofficial" projection of bank credit developments in the fourth quarter on the assumption of no change in money market conditions. The staff member's best guess was that bank credit was not likely to grow much, if at all, on average in the quarter. Admittedly, the projection had to be viewed with caution because of the difficulties of seeing that far ahead.

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

> Recent developments in the monetary and credit aggregates suggest that monetary policy has become tighter during the past few months than in any other period of monetary restraint since World War II. Total reserves at member banks contracted at a 9-1/2 per cent annual rate in the third quarter. The bank credit proxy--even when adjusted for Euro-dollar borrowing and other non-deposit sources of funds--declined at a 4 per cent annual rate. The money supply has not grown at all on balance since late May. And the month-end series on loans and investments at all commercial banks has been slightly negative on balance over the past four months.
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> In contrast to 1966 when supply pressures at thrift institutions had begun to relent before those at banks became really substantial, the cumulative squeeze on banks in recent months has been accompanied by sharp cut-backs in funds available to all of the savings intermediaries, including life insurance companies. This has strongly accentuated prevailing pressures in financial markets.
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> Evidence of the tightness of monetary policy can also be read from recent interest rate developments. Interest rates on all fronts are substantially higher

now than at the end of the second quarter. For a while during mid-summer, deepening constraints on the supply of loan funds did not show through in further general rate advances. Demand pressures had dropped off as summer borrowing by businesses slowed both at banks and in the capital markets. And this had been interpreted by many as evidence that interest rates had peaked.

In September, however, securities markets participants suddenly became aware that the large volume of September financing being undertaken by FNMA and the Federal Home Loan Banks was likely to become virtually a monthly occurrence for some time ahead. Corporate borrowing in capital markets also rose again; bankers began to feel pressures from the fall pick-up in business loan demands; and the Treasury came to market to refinance its large debt maturities. The fact that interest rates turned higher in September was thus not surprising. But the steepness of the further rate advance did come as something of a surprise. In effect, it strongly underlined the extent to which policy has squeezed the availability of loan funds. Also, it reopened the question whether financial institutions and financial markets can avoid becoming seriously unsettled in the weeks ahead, without at least some resumption of modest growth in the supply of money and bank credit.

As the blue book[1/] notes, although there was a small increase in the various measures of the September bank credit proxy, as expected, the October outlook is for renewed contraction in these measures, as well as for a further decline on average in the money supply. At the same time early reports from the thrift industry suggest that savings attrition during the current quarterly reinvestment period is as bad as the industry had feared. Spokesmen for the industry also expect their savings experience to remain weak well into 1970. This means that if the FNMA and the Federal Home Loan Banks are to make good on their commitment to provide

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

continuing support to the mortgage market, combined security financing by the two agencies will probably have to continue into 1970 at least at the recent $1 billion a month pace.

Because of the unusual dimensions and protracted character of this forecast, renewed market concern about the possible emergence of substantially unsettled market conditions has tended to focus on the volume of prospective agency financing. In the near term, however, whether serious unsettlement does in fact develop will depend importantly on the strength of business demands for credit. If projected business spending plans are actually carried out, businesses may seek to draw more actively on their credit lines at banks, while at the same time maintaining or increasing their demands on capital markets. Measures taken to accommodate these enlarged demands could put excessive strains on the liquidity positions of individual financial institutions and intensify the extensive pressures recently prevailing in financial markets.

While the possibility of a full-scale credit crunch cannot be ruled out for the near term, slower economic growth should in time help to moderate pressures on financial markets. The evidence cited by Mr. Partee suggests that some moderation of the earlier buoyancy in aggregate spending is already under way. As this process unfolds there should be some accompanying moderation in total credit demands as well.

Continuation of a policy of zero growth in the money supply and bank credit would thus seem to run some risk in the short run of more severe financial dislocations than we have witnessed to date, if business commitments already made lead to any marked step-up of borrowing demands. On the other hand, a no-change policy also risks triggering a more drastic cutback in aggregate spending than might be desired. On both counts, therefore, a persuasive case can be made for some modest stepping back from the present policy of severe monetary restraint. The principal concern of those opposing such a move is, of course, that any premature modification of present policy may give new life to inflationary expectations and prolong an excessive level of aggregate spending.

> In assessing this latter risk, it should be noted that the policy change proposed in alternative B of the draft directives is an essentially modest move that would have little significant impact on bank credit and money until after October. It would set in train a policy process, however, which over time would tend to promote some moderate renewal of growth in the money supply and bank credit. While this would undoubtedly lead to some downturn of interest rates, the decline would be likely to be large only if bearish business news began to confirm the forecasted slowing in economic activity. In that case the strength of inflationary expectations would be likely to diminish anyway. In any event, it should be stressed that alternative B does not contemplate a shift to an easy monetary policy. It simply seeks to pull back from the present stance of severe restraint. Once the modest character of this change became clear to the public, it is difficult to see why it should reinvigorate inflationary expectations.
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> On the other hand, if present policy is maintained without change, there is a distinct risk that at some later date the System will have to act aggressively to keep aggregate spending from being cut back too deeply. The risk that such a future action will be carried too far and contribute more strongly to longer-run expectations of inflation--as in 1967--would actually seem to be greater than that of any modest move begun now and gradually implemented over the weeks ahead, with the Committee prepared to step back from even this action if events should so dictate.

Mr. Brimmer noted that both Messrs. Partee and Keir had stressed the need for a change in policy at today's meeting. He asked what, in their judgment, would be the consequences of a Committee decision to postpone consideration of such action until the next meeting, which was tentatively scheduled for three weeks from now. He was particularly interested in the likely effect of such a decision on the course of prices during the next three quarters.

Mr. Partee replied that he could not give a precise answer to Mr. Brimmer's question. In general, in light of the broad constellation of factors bearing on prices and the fact that there were lags of some duration in the effects on the economy of changes in monetary policy, the effect of a three-week delay in implementing a modest easing of policy was likely to be rather marginal. In his view, however, that did not necessarily argue for delaying a move toward a more sustainable policy.

Mr. Keir noted that he had suggested adopting alternative B today because he saw advantages in beginning to move gradually toward ease and thus possibly avoiding the need to move aggressively later.

Mr. Mitchell asked whether the staff was prepared to offer projections of the industrial production index and the unemployment rate for the month of December, waiving considerations of possible changes in monetary policy.

Mr. Partee noted that projections contained in the green book[1/] suggested that on average in the fourth quarter

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

the production index would be 175.5 per cent of the 1957-59 base and the unemployment rate would be 3.9 per cent. He would expect December figures to be lower than the quarterly average for production and higher for unemployment, but he was not prepared at this juncture to offer projections any more precise than that.

Mr. Hersey made the following statement concerning international financial developments:

> Looking ahead at our balance of payments and at related aspects of our international financial relationships next year, one has to report once more that the prospects are not quite what you would like. One important new development is that the buildup of Euro-dollar borrowing by U.S. banks from their foreign branches has ceased, so that the United States will no longer get those handsome official settlements surpluses that gave many people in Washington outside this building pleasant feelings about the U.S. balance of payments. From now on, the official settlements balance is likely to show a deficit of about the same magnitude as the liquidity deficit if not larger. On the other hand, it is a fact that some very healthy developments have been taking place.
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> First, after this Committee fully appreciated, toward the end of last year, the size of the job of checking inflation in this country, grounds for anybody's hopelessness about the dollar began to dissolve.
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> Secondly, after a lengthy process of study and negotiation, in which some skillful students and negotiators who are in your midst took part, we have reached a new milestone on the road to a new international financial system, with the first allocation of SDR's.

Thirdly, Germany's pending revaluation of the mark, though it is a response to speculative pressures and though it will serve mainly as a tool of German domestic stabilization policy, can also be regarded as an accommodation to the opinions of the international community. In this respect it will serve as a precedent for the further measures of adjustment which Germany and Japan and Italy and perhaps some others will eventually have to take--through domestic policy, or trade liberalization, or exchange rate changes--to help restore international equilibrium. But a German revaluation of the 7 or 8 per cent now talked of, with its effects partly offset by ending the 4 per cent border tax adjustments, would be regarded by the staff here as utterly inadequate for long-range needs, useful though it might be in quieting speculative capital flows for the moment.

These three healthy developments--active concern about checking U.S. inflation; bold international action to create reserves and, at the same time, to de-emphasize the role of gold; and one more of history's few upward revaluations of a currency--should help us to face other facts with equanimity.

As we shall show you in some detail at the next meeting, there is a very strong probability that the U.S. balance of payments will still be in substantial deficit on the liquidity basis next year, and a considerable likelihood that the official settlements balance will show an even larger deficit. On the liquidity basis, and putting the matter in very round terms of quarterly averages, we expect average deficits next year to be far less than the $3 billion we experienced in the three months May to July, and also considerably less than the $2 billion quarterly rate of the past two or three months, but not as small as the quarterly average of under $1 billion (before reduction by special transactions) that we had from 1966 through 1968.

The difficulties in the way of getting a smaller deficit next year can be restated in familiar terms. On the one hand, prospective credit conditions and present Governmental attitudes toward control programs make it unlikely that the net outflow of long-term capital plus changes in non-banks' short-term assets or liabilities can be held down to the levels of 1966-68. On the other hand, it is going to be a long, slow business to achieve a current account surplus adequate to cover the probable capital outflows, and we will be making no more than a start in 1970, even with cyclical conditions here and abroad favoring the trade balance.

Incidentally, one of the hazards of relying on capital inflows to balance the accounts is illustrated by the fact that in the second quarter of this year U.S. gross payments of interest and dividends to the rest of the world were over $1 billion, twice as much as in the average quarter three or four years ago.

Whatever the liquidity deficit will be next year, the official settlements balance is quite likely to be in even larger deficit. That is to say, foreign central banks will be again accumulating claims on the United States, buying reserve assets from the United States, and repaying reserve liabilities to the United States.

The international financial system can tolerate some sizable gains in dollar reserves, and even benefit from them provided they do not go on too long. Britain and France both hope to achieve gains that will help them to repay debts. Some countries that lost reserves when Euro-dollar interest rates went sky-high need to regain them. Many other countries need steady, moderate, reserve gains over the years, and are prepared to hold some of the gains in dollars. Even big reserve gains next year for Germany and other countries with persistent current account surpluses--assuming those countries fail to counterbalance their surpluses with capital outflows--would not necessarily be too bad a thing, precisely because such reserve gains would point clearly to the need for equilibrating actions more far-reaching than anything they have yet undertaken. At least, that will be the conclusion to be drawn if it is clear that our own inflation is moderating by then.

On the other hand, a big rise in U.S. reserve liabilities to the surplus countries, if it occurs, may force us into disagreeable choices between selling gold, transferring SDR's, and making swap drawings to give exchange value guaranties. Further ahead, the 1972 negotiations for a second allocation of SDR's will be looming up. On all these matters our bargaining position will be weaker the larger our deficit is.

To recapitulate: we are at the end of a period in which massive Euro-dollar borrowings by U.S. banks have saved us from the reserve losses and increases in reserve liabilities the underlying balance of payments position would otherwise have cost us. The underlying position cannot be quickly rectified. To persuade others to adjust, we must moderate our own inflation. The larger our deficit in the years ahead, the more difficult our bargaining position in seeking further development of the SDR system will become. This is a time, therefore, not only for pressing toward price stability but also for exercising caution in relaxing the present restraints on outflows of direct investment and other capital.

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:

Recent indicators of business conditions have been more encouraging than in some time, in that they have pointed more clearly than before in the direction of an economic slowdown. Besides the continuing weakness in housing construction, there is now more evidence of inventory imbalance, although this is confined to the retail and durables manufacturers' sectors. Retail sales over recent months have been sluggish, despite some small recovery in August; and consumer confidence is reported to have declined. Although the most recent jump in the unemployment rate is apparently something of a statistical aberration, there do seem to be real indications that labor market pressures have been moderating of late. Our economists expect a slightly stronger GNP in the first half of 1970 than does the Board staff, but the difference is not great.

While there are encouraging signs that policy is taking hold, I think we should not lose sight of the fact that monthly movements of business indicators can be highly erratic. It is much too soon to gauge the extent of any slowdown, the real question being whether the slowdown will be substantial enough, and of sufficient duration, to bring a significant drop in the rates of price and wage increases. The recent weak performance of the stock market, reflecting in part widespread expectations of a profit squeeze, has been a useful influence tending to cool off inflationary psychology. On the other hand, failure by Congress to renew the surcharge could trigger a renewal of inflationary expectations. Even if the tax is enacted the Federal budget will be having a stimulating influence on the economy in the first half of 1970.

Turning to the balance of payments, we find that the heavy liquidity deficit continued in September, although at a lower rate than in the preceding months. A better trade surplus in August provided some encouragement, as did the reappearance of net purchases of U.S. stocks by foreigners. But these were minor offsets to a generally gloomy picture. The sizable surplus on an official settlements basis that marked the first seven months of the year gave way to a deficit in August and September, reflecting capital flows associated with French and German exchange rate developments as well as the drop in takings of Euro-dollars by American banks. While there is ground for hope that the exchange markets may become much more confident in the coming months if the German exchange rate is settled satisfactorily, the longer-run outlook for our own balance of payments remains precarious.

The banking system continues to be subject to a very substantial degree of restraint. Bank credit, business loans, and bank deposits were weaker in the third quarter than in the second, and these third-quarter rates were generally lower than would seem desirable over the long run.

Nevertheless, I do not believe we should let the summer weakness in the aggregates force us to a premature relaxation of policy, since this weakness could prove to be a temporary aberration and since the evidence of an adequate business slowdown is still inconclusive. The penalty for a premature weakening of policy would undoubtedly be a resurgence of the inflationary spiral which has already proved so damaging to the whole course of the economy.

Under these circumstances I would favor staying with our present policy. Open market target ranges might include a Federal funds rate of around 8-1/2 to 9-1/2 per cent, borrowings of $1 billion to $1.5 billion, net borrowed reserves of $1 billion to $1.3 billion, and a bill rate of, say, 6.90 to 7.25 per cent.

As far as the draft directive is concerned, I have some trouble with the wording describing developments in Germany and their relationship to our balance of payments. It seems to me that it would be more precise to link the flow into Germany with the deterioration in our official settlements balance mentioned in the preceding sentence in the following manner: ". the official settlements balance, which had been in surplus for more than a year, shifted into deficit in part because of new speculative flows into Germany." I would then begin a new sentence,

> reading as follows: "Exchange market tensions were reduced somewhat when the German Government decided to cease temporarily official sales of marks, after which the exchange rate for that currency rose above the official parity." This wording I think more clearly describes the current situation and relates it to the references to exchange market uncertainties in the previous directive that the staff now proposes to delete. As far as the second paragraph is concerned alternative A is satisfactory. The two-way proviso might well be retained, but in the light of the recent slow growth of credit and money and the expected weakness in October, I would be much more concerned if the actual figures turned out to be even weaker than I would be if they were appreciably stronger than the projections. The Manager will have to keep a close eye on developments in the securities markets, where uncertainties on both sides of the fence abound. Incidentally, I believe the burden that heavy new Federal agency financing has been putting on the market situation points up the urgent need for closer Treasury control over borrowing by all Federal and Federally-sponsored agencies, whether or not their outlays are included in the Federal budget.
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> As the Committee knows, I have felt uneasy for some time over the serious financial distortions created both in this country and abroad by the wide disparity between the Regulation Q ceilings and current market interest rates. I would like to see some relaxation of those ceilings, especially on large CD's but only if the method and timing of such relaxation are unlikely to create an impression of a general easing of monetary policy. I recognize the inherent difficulties, but I think it is important for the System to be considering ways and means for extricating ourselves from an artificial and undesirable situation created by over-use of Regulation Q in recent years as an instrument of general credit policy.

Mr. Hayes then noted that Mr. Solomon had suggested a modification of the revised language he had proposed for the directive, in which a reference to Euro-dollar flows would be included as part of the explanation of the deterioration in the official settlements balance. Specifically, Mr. Solomon had suggested language reading

"...the official settlements balance, which had been in surplus for more than a year, shifted into deficit, reflecting slackened Euro-dollar borrowing by U.S. banks and new speculative flows into Germany." The choice between his initial proposal and Mr. Solomon's suggested modification depended on the answers to certain technical questions, and he was not sure at the moment which form of statement was the more appropriate.

After discussion of the technical questions involved, Mr. Hayes said Mr. Solomon's suggested modification was acceptable to him.

Mr. Morris said that for the first time since he had been attending Committee meetings he believed there was persuasive evidence that the economy had begun the process of cresting and that there would be a major turning point in economic activity in the months immediately ahead. The evidence was persuasive not because the changes in the key economic measures had been so large; on the contrary, thus far the changes had been quite modest, with the single exception of the unemployment rate. The evidence was persuasive because it was so widespread. Signs of weakness could now, for the first time, be identified in almost every sector of the economy and the beginning of a declining trend could be seen in the great majority of leading indicators.

Mr. Morris thought it would probably take 6 to 10 weeks for the word to spread to most sectors of the business community, but the word was now spreading in the more sophisticated sectors. At the Boston Bank's board meeting yesterday, after the 4 per cent unemployment rate for October was reported, he asked one of the directors, the chief executive of a large conglomerate, whether he had noted any change in sentiment in his company recently. The director in question had earlier been a strong advocate of tight money. In reply to the inquiry he said his division managers, who had submitted budget figures for 1970 about a month ago, had been calling him to ask for an opportunity to revise their budgets downward. Mr. Morris had asked whether that was due to a decline in new orders and the answer was that it was not--rather, it was in response to what people in the Federal Reserve called the "tone and feel" of the market. Those in less sophisticated business circles, however, continued to report no slowing in activity.

Mr. Morris commented that a much slower reaction in prices should be expected in 1969 than in 1966. Because producers were operating under much more severe cost pressures now than in 1966, a lagged response in prices was likely. Consequently, he believed that the behavior of prices would be a poor guide to monetary policy. If policy were based on price behavior, he thought it inevitable that the impact on real economic activity next spring would be more powerful than the Committee desired.

Turning to the financial sector, Mr. Morris remarked that the Committee was moving into uncharted territory. The financial system had now been operating under severe restraint for a longer time than during any period in the postwar years. Disintermediation, which for many months had been concentrated in large commercial banks, had now spread in a major way to smaller banks, to savings and loan associations, and to mutual savings banks--institutions which were much less well situated to bear up under prolonged pressure. Liquidity pressures were also growing for insurance companies. In July policy loans had been the major source of pressure. The policy loan situation was continuing, but added pressure was now coming from a decline in mortgage prepayments.

Mr. Morris thought the time had clearly come to make a modification in policy. The modification should be not to ease but to a reduced level of restraint. It was too early, from the standpoint of market expectations, to make an overt policy change. It was for that reason that he would continue to oppose any change in Regulation Q ceilings at this time. In his judgment an increase in the ceilings would be interpreted as an overt move by the System with almost as much significance as a reduction in the discount rate.

However, Mr. Morris continued, the time was ripe to move to the policy described in alternative B of the draft directives. He thought the Committee should have moved to such a policy earlier, even though the statistical base for the move was then incomplete. The Committee now had the evidence and he believed it should be acted upon.

Mr. Morris observed that if the inflationary psychology was to be liquidated the System would probably have to pursue a moderately restrictive policy for a number of months to come. It would be much easier to accomplish that if it did not overstay the present policy of severe restraint.

It was for those reasons, Mr. Morris concluded, that he would support alternative B of the draft directives.

Mr. Coldwell said his comments on the conditions in the Eleventh Federal Reserve District would be limited because in many ways the current economic trends mirrored those of the national economy. The mixture of gains and losses in economic indicators still reflected an economy operating at a very high level. Industrial production in Texas continued upward, contrary to the recent national pattern, but the index for the State was heavily weighted by crude oil output and refining. Plant capacity was not a barrier to further output gains, and modernization had reduced the labor inputs required. Nevertheless, labor was a prime constraint and in the coming seasonal expansion it might pose exceptional difficulties. Just one straw in the wind would illustrate the situation. The State Fair of Texas opened on Saturday but not all the 1,200 jobs available for the two-week run could be filled and some exhibitors were short-handed.

Credit demands appeared to remain large and persistent, Mr. Coldwell observed, and many businessmen complained of short supplies of credit. One must, however, point out that most prime credits, even for the massive Alaskan lease sales, were satisfied one way or another. The private use of Euro-dollars appeared to be gaining acceptance as a way of both temporary and longer-term financing.

Mr. Coldwell thought the trend of the nation's economy over the summer months was inconclusive. For those looking for a slowdown, there were more declines evident in such statistical series as orders, sales, and production; inventory accumulation also seemed to point toward reduced strength. For those who looked for strength, the minor jiggles in statistical indicators could be explained away by summer seasonals, strikes, and the many economic and political uncertainties. The strength of personal income and of Government spending, both present and proposed, augured for at least a continued high-level operation. The estimate of a more than $16 billion gain in GNP in the third quarter, even though heavily weighted with price change, provided further evidence of additional deferment in the slower economic pace being sought through monetary and fiscal restraints.

Mr. Coldwell remarked that the position at the beginning of the fourth quarter of 1969 was somewhat different from that at the beginning of the third quarter. However, interpretation of recent changes was still subject to reasonable differences, and the future pattern of economic developments remained clouded with doubt. It was certain that housing construction was headed downward and, relative to its demand, was in a weaker condition. He did not believe the Committee could be so sure of the other basic trends, although retail sales had been flat and factory output and employment gains had slowed. The strength of personal income and capital expenditures provided a strong support to the economy, and perhaps enough to see it through a period of weakness elsewhere.

Money market conditions of recent weeks had shown a pattern of rising yields on longer-term securities but fairly stable rates on short-term securities, Mr. Coldwell noted. Three-month bill rates had changed little, remaining generally in a narrow range of 6.95 to 7.15 per cent. Federal funds rates, though averaging higher, had been above 9-3/4 per cent on fewer days and the volume of transactions in such funds had moved up another notch, demonstrating fairly easy availability. But yields on longer-term securities had advanced materially and the market for municipals had deteriorated. Perhaps one should be thankful that the recent municipal issue cancellations and slow sales had not precipitated a disorderly market and that the price reductions had come at a slow but fairly steady pace. The upset in the international monetary situation, coming on the heels of the unfortunate Treasury borrowing problem and the tax-and-dividend-date credit demands, had complicated both the Desk's operations and the interpretation of recent money market indicators.

Mr. Coldwell said he was grateful to Mr. Maisel for his comments at the last meeting, for he thought they spelled out at least a potential difference in the members' orientation--or even in their fundamental outlook--on policy targets. He hoped that Mr. Maisel did not mind that he differed with him in the parameters of the various positions he had outlined because--despite his (Mr. Coldwell's) obvious leanings toward the short-run money market conditions and the psychological and interpretive problems in the market--he blended into his approach many, if not most, of Mr. Maisel's credit supply, borrowing, and monetary aggregate considerations.

Mr. Coldwell did not believe the positions were mutually exclusive, as he interpreted Mr. Maisel's statement to imply. In his opinion, money, credit, and interest rates were not matters which could be divorced from market attitudes, bank adjustment procedures either on or off the balance sheet, and, importantly, the expectations of borrowers and lenders. He would agree that the pool of liquidity in the economy, wherever placed, had been drawn down by borrowers over the past nine months, but the real question was whether the springs feeding the pool were maintaining a flow adequate to sustain an inflationary rate of economic advance. On that latter point, he had to disagree with Mr. Maisel's implied negative position. Moreover, he believed the inflationary potential reflected in business and consumer attitudes, the heavy wage settlement increases, and the continuously rising cost base still posed a grave threat to economic stability over the coming months. To his way of thinking, the Committee was still sustaining a rate of advance incompatible with long-range economic stabilization, and with each passing month the force of expectations of further inflation brought potentially disruptive factors closer on the economic horizon.

One must admit, Mr. Coldwell continued, that bank reserves had been held on a short rein and, in fact, had declined recently. But the impact of that development was mitigated by the rise of the large nonbank credit accommodations and the shift of funds from bank time deposits to direct investments and indirect support of the Euro-dollar and commercial paper markets. The recent definitional and adjustment changes in the money supply series obscured trend interpretations but seemed to imply a rate of money creation beyond that sustainable for a corrective position.

Mr. Coldwell thought that in its search for the proper degree of restraint to disinflate but not repress the economy the Committee should take cognizance of both the lag requirements for policy action and the fairly immediate money market and expectational effects. The Committee's problem was with linkage, degree of lag, and, most importantly, the weighing of relative risks.

Today Mr. Coldwell was persuaded that monetary policy would remain the sole bulwark against inflation and thus had to exercise its limited effect on the side of restraint. If Congress permitted enlarged spending and did not renew the surcharge or eliminate the investment tax credit, the System's position in his judgment would become even more difficult and perhaps untenable. But the System had to do what it could and, by persistence, hope for a return to sustainable noninflationary growth in the economy. He would thus seek to maintain a feeling of strong restraint on all financial markets until the Committee could be sure that easing its policy would not regenerate inflationary trends or validate cost and price expectations.

Mr. Coldwell said he had no fundamental disagreement with the general pattern of money and credit conditions cited in the blue book as consistent with the maintenance of prevailing conditions.[1/] However, he would place less emphasis upon statistics and more on the tone and expectations of the market. Where obvious external pressures forced large shifts in the demands for or supply

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1/ The blue book passage referred to read in part as follows: "Maintenance of prevailing money market conditions might be considered to include a weekly average Federal funds rate fluctuating between 8-1/2 and 9-1/2 per cent, member bank borrowings in a $1 $1-1/2 billion range, and net borrowed reserves in a $900 million to $1.2 billion range. Given these conditions, however, it seems likely that the 3-month bill rate would fluctuate in a somewhat higher range than recently--perhaps between 6.90 and 7.40 per cent.

Should the bill rate climb enough to bring unfavorable market repercussions, it may be necessary to move toward the lower end of the recent range of fluctuation of the Federal funds rate and marginal reserve measures in order to maintain unchanged overall conditions in money and short-term credit markets."

of funds or securities, he would be willing to let the force of such temporary moves show through the interest rate pattern. He would object to a steady downtrend in interest rates, net borrowed reserves, or borrowings; but he would similarly object to a steady uptrend in such measures if carried to the point where the market interpreted it as a change in policy toward greater restraint. A shift in policy today following on the heels of the 4 per cent unemployment rate would validate the opinions of those businessmen who thought that as soon as unemployment moved up the Federal Reserve would ease its policy. He could not stress too strongly the very grave risks of validating the credibility gap and recreating the expectations for renewed inflationary pressures.

Mr. Coldwell said he would, of course, favor alternative A of the draft directives. With respect to the first paragraph, however, he questioned how firmly based was the statement in the opening sentence on inventory investment, and he objected to the projection of slower over-all growth.

Mr. Swan reported that general business activity remained at a high level in the Twelfth District. As had been expected, however, the unemployment rate in the Pacific Coast States rose in August to 4.7 from 4.5 per cent in July; and it appeared that employment in two major categories--aerospace and construction--would probably act as a drag on the general employment situation in the months ahead.

As to the national situation, Mr. Swan continued, he recognized the various uncertainties in the picture but, like Mr. Morris, he thought that indications of peaking in the economy were becoming increasingly evident. He subscribed to Mr. Keir's view about the advantages of a gradual shift in policy at some point over an abrupt shift at a later point. At the same time, he also agreed that the Committee would not want to reestablish a credibility gap with respect to its intentions, and accordingly he would not want to take any action now that would be interpreted as an overt move. In his view, however, there was room for some very slight move away from the present degree of monetary restraint. He favored a continuation of firm restraint, but with slightly less firmness than had developed in the last few weeks when the situation created by the Treasury's problem with its cash balances was being unwound.

Mr. Swan commented that the difference between the conditions associated in the blue book with alternatives A and B of the directive did not seem to him to be great.[1/] In particular, if--as the blue

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1/ The blue book discussion associated with alternative B read in part as follows: "If the Committee should decide to move toward somewhat less firm money market conditions, it might consider a Federal funds rate averaging around 8-1/4 to 8-1/2 per cent, member bank borrowings around $1 billion, and net borrowed reserves of around $800 million. Over the short run, such a move would seem unlikely to lead to sharp reductions in interest rates or to much change in monetary aggregates (as compared with a situation of no change in money market conditions). Interest rate declines would, of course, tend to be larger if market expectations were at the
(Continued on page 57)

book suggested was a possibility--bill rates came under upward pressure and the money market variables were therefore permitted to move to the lower end of the ranges indicated in connection with alternative A, the targets for those conditions would be quite close to those indicated in connection with alternative B. The difference between the two alternatives would be even smaller if A were associated with an understanding that in interpreting the proviso clause emphasis would be placed on offsetting shortfalls from the projection of the bank credit proxy. Nevertheless, he favored alternative B. He would much prefer, however, to call for "slightly" rather than "somewhat" less firm conditions.

Mr. Swan noted that another alternative for the second paragraph had been distributed to the Committee yesterday by Messrs. Mitchell and Maisel.1/ Although he suspected that he

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(Continued from page 56)
same time being affected by bearish business news. But banks would not be in any position to bid effectively for domestic CD's and thus would find it difficult to fuel downward pressures on longer-term interest rates by rebuilding their own portfolios and financing speculators. However, it is likely that banks would find the market for commercial paper a somewhat more attractive source of funds at the margin as short-term interest rate pressures abated. Also other types of investors, such as pension and mutual funds--where fund flows have been less restricted, might step-up their commitment of funds to long-term markets."

1/ The directive language proposed by Messrs. Mitchell and Maisel 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 conditions in money and short-term credit markets consistent with the prevailing firm monetary and credit restraint; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections."

might find their proposal acceptable, he was not sure he understood how they intended it to be interpreted.

Mr. Galusha said it might be helpful if Messrs. Mitchell and Maisel would explain their proposed language before the go-around continued, and the Chairman agreed.

Mr. Maisel remarked that the second-paragraph language he and Mr. Mitchell had proposed was intended to meet a problem the Committee had faced for some months and which was reflected in some of the comments already made in today's go-around. The quandary, as he saw it, was that the members did not want policy to become steadily more restrictive; at the same time, they did not want to adopt directive language that would suggest a move toward ease because of the risk of undesirable effects on psychology. Rather than calling for a move toward "somewhat" or "slightly" less firm money market conditions, he and Mr. Mitchell had proposed language that would make clear the Committee's intent to maintain firm monetary and credit restraint without intensifying the degree of restraint.

In reply to a question by Mr. Clay, Mr. Maisel said the money and short-term credit market conditions he would consider consistent with the directive language he favored were those given in the blue book for alternative B of the staff's draft.

Mr. Mitchell said he agreed with Mr. Maisel's view that monetary policy had been tightening steadily in recent months while the Committee had been agreeing on "no change," and that further tightening was neither necessary nor desirable. Evidence that policy had tightened recently was contained in a table in the blue book which compared annual rates of change in various monetary aggregates in the first six months of the year with those in the next three months. Running down the table, the behavior of total reserves changed from an increase at an annual rate of 0.7 per cent in the first half to a decline at a -9.6 per cent rate in the third quarter; the rates of decline deepened for nonborrowed reserves from -3.7 to -5.1 per cent, for the unadjusted proxy from -3.5 to -9.2 per cent, and for the proxy plus Euro-dollars from -0.2 to -6.0 per cent; the growth rate fell for total loans and investments from 3.0 to 0.1 per cent and for the money supply from 4.3 to 0.2 per cent; and the contraction of time and savings deposits increased from a rate of -4.0 per cent to -13.1 per cent. Thus, the situation with respect to every aggregate listed showed deterioration in the third quarter. To be sure, the deterioration in July and August alone was worse than for the quarter as a whole, since there was some general improvement in the aggregates in September.

For additional evidence of the recent tightening, Mr. Mitchell continued, one might look at the table on "key interest rates" shown in the supplement to the green book. Of the 23 types of securities for which rates were listed, 14 had reached highs in September or early October; of the eight intermediate- and long-term issues for which recent quotations were given, all had reached highs in that period. Other evidence of the recent tightening could be found in the reports contained in the staff materials concerning developments at savings and loan associations and life insurance companies. That kind of tightening, in his judgment, was incompatible with the Committee's stated posture of "no change."

Mr. Mitchell went on to say that, as Mr. Maisel had indicated, the purpose of their proposed directive language was to emphasize the objective of avoiding further tightening. He disagreed with Mr. Maisel however, on the best means for accomplishing that objective. In his (Mr. Mitchell's) view the Committee should focus on demand deposits and the money supply, seeking growth in the former in October and November at about a 4 per cent annual rate. Given present Regulation Q ceilings, there might well be further reductions in time deposits; and the reserves so freed--and new reserves supplied--would likely be used to support expansion in demand deposits. In his judgment that variable was a more reliable guide for policy than the credit proxy or any of the other aggregates, even given the difficulties recently encountered in its measurement.

Mr. Mitchell concluded by saying that if monetary policy continued to tighten as it had recently the result was likely to be a major recession in 1970. The fact that there had not yet been much effect on prices did not alter his view on policy, since he thought the economy could stagnate before such effects were marked.

Mr. Galusha noted that the Minneapolis Reserve Bank had decided to postpone construction work on its new building until late spring of next year. It was a decision totally indefensible in a business sense, of dubious economic merit given the cash flow during construction, and, quite bleakly, one for which the Bank saw no alternative. The enemy was still public psychology and there was little real evidence of change. True, there were doubts being publicly expressed by a few, but the fire had hardly been dampened.

In some respects the Committee's plight today was similar, Mr. Galusha said. The data did support a conclusion that the economy was slowing. The sobering and unequivocal statements of Messrs. Partee and Keir and his great respect for their professionalism gave him assurance. Continuing negative growth rates for many if not all of the monetary aggregates were evidently consistent with the green book GNP projections, so perhaps he should not be nervous. Nevertheless, he was. He did not believe the Committee could continue with that pattern for more than a few weeks.

However, Mr. Galusha continued, the Committee was battling for credibility, and he could not see running any risk of appearing to ease during the next few weeks. Accordingly, he believed the Committee had to hold to its current policy stance. He would not attempt to specify the levels of variables that would be involved in holding to a posture of continued restraint while avoiding further tightening, but he favored alternative A for the directive. To his mind, adoption of alternative B would constitute a move toward ease, no matter how close the targets under that alternative were to those under A. He drew some comfort from the fact that there was only a three-week interval between today's meeting and the next one.

In a concluding comment Mr. Galusha said he was afraid the income tax surcharge would be permitted to expire at the end of the year, rather than being extended at 5 per cent in the first half of 1970 as the Administration had recommended. If that happened, the unfortunate situation would again arise in which fiscal and monetary policies would be working at cross purposes.

Mr. Scanlon reported that the past month had provided additional evidence in the Seventh District that anti-inflation measures were slowing the rise in total spending. Reduced momentum in consumer spending and moderate declines in orders for machinery and equipment could now be set alongside the sharp drop in residential construction as signs of a change in the underlying trend of activity. Also, there appeared to have been some erosion in business and consumer confidence. But labor markets continued very tight, and upward pressures on wages and prices had not abated.

Mr. Scanlon remarked that an assessment of attitudes in business and financial circles in the District indicated a widely held view that a leveling trend in total business activity would be clearly evident in the next few months. Considerable agreement was found that the movement in aggregate measures of activity would resemble, in broad outline, the Board staff's projection.

Loan demand at District banks had continued strong in recent weeks, Mr. Scanlon said, but much of the demand appeared to be related to such special and temporary factors as corporate tax payments and the purchase of Alaskan oil leases. The tendency for firms to rely more on the commercial paper market as a regular source of financing might have increased seasonal shifts in bank loans associated with tax and dividend dates. Also, part of the current demand for bank loans probably reflected the need to finance larger inventories.

Banks in the District appeared to have experienced a spurt in business loan growth in September, after only slow growth in July and August, Mr. Scanlon continued. With deposits level and with no further increase in funds from Euro-dollar and other continued very tight, and upward pressures on wages and prices had not abated.

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Banks in the District appeared to have experienced a spurt in business loan growth in September, after only slow growth in July and August, Mr. Scanlon continued. With deposits level and with no further increase in funds from Euro-dollar and other nondeposit sources, loan expansion at Chicago banks had been alternative A of the draft directives on the understanding that there would be no further tightening.

Mr. Clay said that information on the performance of the national economy continued to suggest some further moderation in the pace of activity, but the signals were still mixed. For example, the September labor force figures seemed to confirm some easing in labor markets in recent months. On the other hand, recent National Industrial Conference Board capital appropriations data and private capital spending surveys for 1970 suggested significant advances. And September automobile sales were substantially stronger than anticipated. On balance, the economy continued to operate in a strongly inflationary environment of costs and prices with aggregate dollar spending in the quarter just concluded slightly larger than in the previous quarter. The anticipated smaller growth of the fourth quarter was still substantially a matter of projection.

Public economic policy still had an important job of restraint to perform in the months ahead, Mr. Clay continued. Unfortunately, the duration of the current level of restraint of fiscal policy had become increasingly uncertain.

Mr. Clay noted that credit markets and financial institutions had been under severe pressure in recent weeks. Most interest rates in the money and capital markets had moved up sharply again since the last meeting of the Committee. There was a possibility of further intensification of pressures on interest rates and availability of funds in the weeks ahead. Nevertheless, the strength of aggregate demand, the wage-price pressures, and the uncertainties of fiscal policy appeared to leave little alternative except to continue essentially the same policy for the present.

Mr. Clay said that alternative A of the draft policy directives appeared to be in line with that approach. He certainly agreed with Mr. Mitchell that there should be no further tightening.

Mr. Heflin said that in the interest of conserving time he would submit the statement he had prepared for inclusion in the record. The statement read as follows:

> The general tone of our latest information on Fifth District business remains much as it has been over the past two months. Our September survey suggests that the decline in residential construction may have accelerated in recent weeks and that industrial and commercial building may now also be feeling the pinch of tight money. Bank loan expansion appears to have tapered off somewhat, although this is probably due more to the strapped reserve positions of our banks than to any diminution in demand.
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> At the national level, there can be little doubt that the latest data, as they now stand, provide more evidence of moderation than we have seen in over a year. The recent figures on industrial production, the rise in unemployment, and signs of some involuntary inventory accumulation could be important straws in the wind. Considering these signs along with the deteriorating situation in the construction sector, growing evidence of consumer resistance to high prices, and projected

cutbacks in Federal spending, I can appreciate the argument for some relaxation of the current tight policy posture.

But it is also clear that other important categories of expenditures remain strong and that upward pressures on prices are as persistent as ever. Also, despite Administration and Congressional pronouncements to the contrary, significant cuts in Federal spending over the months ahead appear increasingly doubtful. On top of this, the 10 per cent tax surcharge is scheduled to run out at the end of the current quarter, with little prospect of renewal at any more than half the old rate, while repeal of the 7 per cent investment tax credit seems doubtful at this juncture. In brief, there would seem to be good reason to question the fiscal assumptions underlying the GNP projections in the green book.

Apart from all this, it is by no means obvious that we have yet made satisfactory progress with the expectational aspect of the inflation problem. As a matter of fact, it seems to me that we may have lost some ground in this connection lately. I find it discouraging, for example, that the recent sharp run-up in bond yields might reflect a resurgence of market expectations of a continuing boom. In addition, we seem to be seeing an increase in the number of forecasts of a strong business performance in 1970. This is all the more disturbing in view of the growing indications that preliminary third-quarter data, to be published shortly, will show some step-up in the rate of GNP growth.

We have seen some significant--and, I think, altogether desirable--developments in the international exchanges over the past two weeks but these would appear to have little bearing on today's policy decision. Rather, I think that the current policy question must be settled on purely domestic grounds. On that basis, the issue seems to me to be a close one. The statistics quite plausibly can be translated into an argument that we are approaching the point at which we need to ease. I would be more convinced of this if I had more faith in the credibility of the current data and especially in our projections of inventory accumulation and Federal outlays. But for my part, I am more impressed with the need to complete the job of dissipating the climate of inflationary expectations if we are to return the

> economy to a sustainable growth path. Any easing at this time, it seems to me, might prejudice our ability to achieve this aim. Since I am inclined to give precedence to this part of the problem, I would oppose any measure that might be construed as a move to an easier posture at this time. I favor maintaining the existing degree of market restraint for at least a while longer.

Mr. Heflin added that his policy views coincided with those of Mr. Galusha. In his opinion the policy prescriptions of the staff and of Messrs. Morris and Swan involved a degree of fine tuning which he did not think was feasible. He thought the principal problem remained that of inflationary expectations. The question of timing was important, and he concluded that the Committee should wait another three weeks before considering a policy change. Accordingly, he favored alternative A for the directive today.

Mr. Mitchell said he was pleased to hear so many speakers observe that they were opposed to further tightening, but the problem remained of how to prevent it.

Mr. Swan remarked that comments in opposition to further tightening were not new; such views had recently been expressed at meeting after meeting.

Mr. Mitchell then said he thought the problem derived from the Committee's failure to use appropriate variables in the second paragraph of the directive. At the last meeting he had proposed use of the concept "monetary aggregates" in the proviso clause, but that suggestion had not won much support. By continuing to use the concept of bank credit, with all of its limitations, the Committee was not giving the Manager anything he could actually work with--and that, in his judgment, was why policy had been getting tighter.

Mr. Daane said he shared Mr. Galusha's sense of frustration and came out on policy where Mr. Galusha had. He agreed that the problem was one of timing, and his inclination was to wait until the meeting three weeks from now before considering a policy change. The problem of declining monetary aggregates would remain even if the Committee adopted the directive language proposed by Messrs. Mitchell and Maisel; Mr. Maisel had indicated that that language was intended to be consistent with the money market conditions associated with alternative B, and the staff's projections suggested that the aggregates would decline almost as much in October under the alternative B specifications as they would under those for A.

Mr. Daane noted that the staff had opted for alternative B today in light of their longer-run projections for economic activity. But he did not share the assurance of Messrs. Partee and Keir that such a policy decision would not provide stimulus to inflationary psychology. It was because of such a concern that Mr. Morris did not favor a change in the Regulation Q ceilings; nevertheless, the latter did favor alternative B for the directive. He (Mr. Daane) thought that if the Committee adopted B--or the Mitchell-Maisel language--that action was likely to become known and to be regarded as an overt easing action, with all the consequences of such an interpretation for inflationary expectations.

Mr. Daane said he did not think the point had arrived at which the Committee should take such a step. He favored alternative A for the directive, with the amendment proposed by Mr. Hayes as modified by Mr. Solomon.

Mr. Maisel said that while he disagreed with Mr. Daane's conclusions he thought the latter had posed the problem well. Mr. Daane's comments seemed to imply that the Committee's policy either had to be too tight or too easy; in other words, that it would almost always be wrong. If that were the case, there obviously was something basically wrong with the form of the Committee's directive.

Data for the last four months indicated to Mr. Maisel that the Manager had not been focusing on net borrowed reserves, member bank borrowings, or the bill rate as a guide to operations. Rather, it appeared that he had focused on the Federal funds rate, which had generally fluctuated in a 9 to 9-1/2 per cent range. If the Committee were to take the position that setting a target for the funds rate outside of that narrow range would constitute a change in policy, it would be locking itself into a posture in a way that would have highly unfortunate implications for the long run.

Mr. Maisel noted that directives with second paragraphs like that of the current one had been in existence since the end of April. During that period net borrowed reserves had reached a negative peak in May and had become shallower each month since. Interestingly, however, the discussion of prospective developments in the current blue book appeared to call for a reversal of that trend by moving toward deeper net borrowed reserves on average in October. The trend in borrowings had followed a path similar to that of net borrowed reserves. That apparent decrease in pressure on the net reserve position was not, however, reflected in interest rates. Apparently, banks had reacted to administrative pressures and to reductions in liquidity as well as to the actual level of aggregate borrowings. As a result, there had been a steady increase in interest rates on all types of instruments, ranging from Federal funds to long-term bonds. All had recently reached new peaks, though the directive during that period called for maintenance of prevailing conditions.

Mr. Maisel observed that the effect of directives of the existing type became even clearer if one examined the behavior of the monetary aggregates in the third quarter compared with that in the first half of the year. As Mr. Mitchell had noted, those comparisons were made in a blue book table. Total reserves had, on average, increased slightly in the first half of the year but had fallen at an annual rate of almost 10 per cent in the third quarter; total loans and investments and the money supply had been virtually flat in the third quarter compared to growth rates of 3.0 per cent and 4.3 per cent, respectively, in the first half; and all other rows in the table showed similar reactions to the Committee's maintenance of "prevailing firm conditions in money and short-term credit markets."

Again, Mr. Maisel said, it seemed clear to him that no matter what one's view of current economic conditions might be--and he personally was willing to accept the staff's view--one should not want monetary and credit conditions to grow more and more restrictive. That was what had been occurring under the current directive. It was what was projected to occur if the current directive was not altered.

Mr. Maisel noted that the question had been raised as to the costs of delaying action for another three weeks. As he had tried to indicate at other meetings, the longer the Committee delayed in altering its directive the greater was the danger that a change needed to obtain control of its own operating procedures would be confused with a change in goals or policy stance. It was likely to be assumed either that the Committee was questioning the validity of its current policy of restraint or that it was shifting policy on the basis of new economic forecasts. It would have been better if the Committee had acted four weeks ago, but there still was an opportunity today to differentiate between procedural and policy objectives.

Mr. Maisel remarked that the Committee should be concerned today with the procedures that would enable it to maintain firm monetary and credit restraint while following the desire of a majority of the members that it not tighten monetary policy further. That could be done if the Committee took a more flexible approach to the Federal funds rate and the rate for three-month Treasury bills. In order to stop the process of steadily growing restraint it was necessary to introduce a good deal more flexibility into the money market targets given to the Desk. If more fluctuations were introduced in money market conditions the Committee could avoid the threat to its credibility. It could increase pressure periodically if that was necessary to maintain the public's view of its stance. Such additional pressure could be applied if the monetary aggregates or the tone of the market indicated that a change in expectations was occurring.

Mr. Maisel commented that it was likely to be considerably harder to make the necessary change in procedure three weeks from now than it was today. The directive language he and Mr. Mitchell had proposed was designed to make clear that the object was to deal primarily with operating procedures. He hoped the Committee would take the present opportunity to make a change that in his judgment was necessary.

Mr. Brimmer said he thought the Committee should not let Mr. Hersey's comments on the discouraging outlook for the U.S. balance of payments pass without notice. The modifications in the foreign credit restraint program now under consideration by the Administration would do nothing to help; if anything, they would aggravate the difficulties. At this juncture it was extremely hard to assess the probable course of the over-all balance of payments in 1970. However, it was the considered judgment of some of those working in the area that if there were no substantial change in the restraint programs the deficit in the balance of payments on the liquidity basis in 1970 might be anywhere between $4.5 billion and $5 billion, abstracting from the effects of any special transactions. In short, the prospect was for little if any improvement in the liquidity balance from 1969 even with no change in the programs. Rough estimates indicated that under one set of proposals for relaxation in the Commerce Department program the outflow on direct investment abroad of U.S. corporations would be $1/2 billion greater in

1970 than in 1969, and that under another set of proposals the rise would be of the order of $1 billion.

Mr. Brimmer remarked that in considering policy it was important for the Committee to keep in mind that outlook for the balance of payments as well as the prospects for the domestic economy. With respect to policy questions in general, he was disturbed that at this late date the Committee was still debating the question of techniques. Also, he thought it would be unfortunate for the Committee to adopt the staff's proposal for a change in policy without having the kind of comprehensive assessment of the economic outlook that would be provided in a chart presentation. A chart show was planned for the meeting three weeks from now, and he would favor waiting until then before considering a policy change.

In his judgment, Mr. Brimmer continued, the fundamental question was whether the Committee was willing to maintain a policy of restraint long enough to make substantial progress toward price stability. The GNP projections given in the green book made it clear that a substantial amount of inflation remained in prospect; the projections suggested that the GNP deflator would still be rising at an annual rate of 3.2 per cent in the second quarter of 1970. He was not sure that the GNP deflator was the most appropriate measure of prices to use in that connection, but whatever measure was used the expectation was for the persistence of considerable inflationary pressure in the period ahead.

Moreover, Mr. Brimmer said, under what was now being described as severe and increasing restraint--a description with which he did not agree--real GNP was projected to decline only slightly if at all in the first half of 1970. One might ask whether the Committee was prepared to accept any decline in real GNP as the price of dampening inflationary pressures. For himself, the answer was yes.

In Mr. Brimmer's judgment it would be extremely unfortunate for the Committee to vote in favor of a policy change one day after it was reported that the unemployment rate had risen to 4 per cent, since it would appear that the change had been triggered by that report. He agreed with Mr. Daane that the Committee's action would become known quickly. Given the prevailing inflationary psychology, the Committee should not leave the impression that it had reacted to the first significant increase in the unemployment rate. For similar reasons, he would not want to raise the Regulation Q ceilings at this time.

Mr. Brimmer then observed that the Committee should not overlook the fact that banks were increasing their reliance on the commercial paper market. From mid-August to late September, the number of bank-related institutions, including one-bank holding companies, issuing such paper had risen from 39 to 49, and from June until the present the volume of such paper outstanding had increased from about $1 billion to about $2 billion. It was clear that banks were still reaching for funds from any available source, and he thought the System should not make it easier for them to obtain funds. He had mentioned the subject of the market for agency issues earlier today. He did not know what guidance the Committee should give the Manager in that area, but he would note that if the System were to buy coupon issues in volume in order to ease market strains resulting from new agency issues, the effect could be the same as that of a general easing of policy.

Mr. Brimmer observed that the subject of fiscal policy had already been stressed. He would add that more and more people were becoming convinced that Federal expenditures would not be held to budget levels. For example, in Seattle recently he had found a widespread conviction that funds for the supersonic transport plane--the SST--would be provided, and the President had already proposed that outlays for the SST be included in the budget. On the whole, the outlook for fiscal policy was not good. The best course for the Committee, in his judgment, was to continue its present policy and to accept the costs of stopping inflation. He favored alternative A of the draft directives.

Mr. Sherrill said he could be quite brief in his comments today. As he was reviewing the materials prepared for the meeting last night, he had come to the conclusion that the ideal situation would be one in which the Committee could bring the decline in the aggregates to an end with no one else being aware that that had been done. While that statement might appear facetious, he thought it revealed the essence of the Committee's problem. There were two sets of factors to be considered--those relating to the realities of the markets and the economy, and those relating to psychology and expectations. To his mind, the latter were the factors of primary importance to the Committee at this juncture. While he would not want to see greater tightness develop because of the underlying realities, he also would not want to give the impression of having moved to a posture of greater ease. In short, he thought that this was not the time to change policy. Accordingly, he favored alternative A for the directive.

Mr. Hickman remarked that recent business developments indicated that the economy was responding to restrictive monetary and fiscal policies, in spite of the slow progress in containing inflation. Final sales weakened in the third quarter, although GNP was apparently stronger than expected largely because of involuntary inventory accumulation.

Unlike similar stages in most previous slowdowns, Mr. Hickman continued, the recent reduction in real activity had not yet been reflected in the Fourth District. The District's manufacturing sector was bolstered in August by the early production start of new model cars and by the related upturn in steel output. Unemployment in the Fourth District had fluctuated in the very narrow range of 2.5 per cent to 2.6 per cent through August of 1969, considerably below the national average of 3.3 per cent to 3.6 per cent; District figures were not yet available for September to compare with the national figure of 4 per cent. Insured unemployment had also declined recently in most major labor markets in the District, chiefly because of developments in the auto industry.

On the financial side, Mr. Hickman said, he was extremely concerned about current market conditions. Interest rates had moved considerably higher since the Committee's last meeting, reflecting extreme monetary restraint, a surge in Federal agency borrowing reminiscent of 1966, an increase in the corporate calendar, and the uncertain state of international markets. Net inflows of savings to financial institutions had deteriorated sharply in the third quarter, and the politically sensitive mortgage market showed pronounced signs of increased pressure.

In Mr. Hickman's opinion, recent developments provided additional support for the view that current monetary policy was inappropriate. He thought that the Committee should permit some minimal expansion in the bank credit proxy and the aggregate reserve measures. Resumption of the degree of restraint prevalent last summer might disrupt the financial system, and it might induce a sharp rise in unemployment while prices were still rising.

It seemed to Mr. Hickman, consequently, that the Committee should set its sights on a modest increase in the adjusted bank credit proxy over the foreseeable future, such as had occurred in September. Because of uncertainties in the fiscal and budget areas, the System should make clear in appropriate quarters that it would not offset the effects of budget stimulus through extremely tight money. Since the "no change" alternative of the staff's draft directives--alternative A--implied a return to the sharp rates of contraction in bank credit of last summer, he would favor alternative B. He would not change Regulation Q ceilings at this time.

Mr. Bopp observed that a policy of "no change" had been operative for most of the time since the beginning of the year. However, behavior of the money and credit aggregates during that period indicated that such a policy might have unintended results. Thus, the most recent estimates of the money supply indicated that, at least by this measure, policy during the first half of the year was less restrictive than the Committee had intended. And, as measured by changes in money and credit, restraint was considerably greater during the third quarter than during the first half of the year.

However, Mr. Bopp said, he did not believe those developments required major policy adjustments now. In spite of the fact that the growth in money was greater than intended during the first half, it was 50 per cent below that of the second half of 1968. The slowdown in the aggregates in the third quarter compensated somewhat for the declines that were not achieved during the first two quarters. On average, the degree of restraint that materialized was close to what he would have chosen.

But in spite of the restraint thus far and even though most of the impact of policy in the third quarter was probably yet to be felt, it appeared to Mr. Bopp that the Committee still had a way to go. Although it was risky to generalize from a small survey, the information obtained from the Philadelphia Reserve Bank's latest survey of business opinion was indicative of the problems yet to be faced. The survey for September indicated that manufacturers did expect economic activity to continue to moderate. Seventy-five per cent of the respondents expected either a decrease or no change in business activity six months ahead.

Nevertheless, Mr. Bopp said, the adjustments they looked for were relatively mild. Despite expected softening in demand, most manufacturers planned to maintain their labor force at the present size. It appeared that they believed the adjustment would be short enough to make it cheaper to hoard labor than to lay people off and subsequently have to rehire workers with scarce skills. The information he had from the Philadelphia banks confirmed the fact that most businessmen expected only a brief slowdown. They reported that the underlying demand was still there and that it would become effective if funds were available.

Locally and nationally, Mr. Bopp continued, it was apparent that a moderation was taking place; it also seemed probable to him that more was needed to get inflation under control. What he feared--and thought had to be avoided--was a slowing too mild to upset the legacy of three years of rapidly rising prices. For then the inflationary psychology would remain. Hence, he believed that the policy stance should remain one of restraint.

For the next three weeks, Mr. Bopp said, he favored a policy of no change. But if it appeared that declines in money and credit were greater than the staff projected, the Desk should take the steps necessary to bring the aggregates back on target even if that involved changes in money market conditions. Likewise, the Desk should prevent the targets from being overshot substantially. In view of the still-pressing problems of inflation, it was especially important to avoid unintended easing at this time.

As to the directive, Mr. Bopp favored the modifications suggested by Messrs. Hayes and Solomon in the first paragraph and alternative A for the second paragraph.

Mr. Kimbrel reported that, in the Sixth District also, more evidence had come to light since the last meeting to indicate that the economy was slowing down. Employment had increased only a little in August. The factory workweek had declined slightly. Auto sales had faltered a bit. Bank lending, which normally went up in September, had not increased until late in the month. In short, many indicators his staff regularly examined for clues to current conditions in the District as a whole were not as rosy as they had been.

One major exception, Mr. Kimbrel said, was the situation in the Mississippi Gulf Coast area, where some improvement had occurred. The apparel industry was almost back to full production. More than 300 workers had found jobs as the result of the return of the banana boats to the port of Gulfport. Of course, some sectors in the area still lagged. But as rebuilding programs accelerated, sharp increases should be expected in construction jobs.

Mr. Kimbrel noted that now, with the passage of time, there was a much clearer picture of the impact of the recent hurricane. Immediately after the storm more than 50,000 were out of work in Mississippi. The hurricane itself wiped out 6,000 jobs in the Biloxi-Gulfport area, and the unemployment rate there went from about 4 to 17 per cent. Yet, elsewhere in the District unemployment had remained at a very low level. If that were not the case, he would be far more worried about the economic situation than he was.

Also, Mr. Kimbrel continued, he would have been more concerned if the housing sector were undergoing a massive shake-out. To the contrary, the experience was that total construction contract volume had continued strong in August. Apartment building was still vigorous, although financing had become increasingly difficult and expensive to arrange. He expected building activity to ease in the months to come, since commitments were shrinking and savings flows had weakened.

It seemed to Mr. Kimbrel there were even more indications of a slowing in economic pace on the national scene than in the Sixth District. Therefore, he could understand the uncomfortable feeling some members had about the Committee's present policy stance. Certainly, no responsible policymaker wanted to maintain restraint indefinitely, even though he might believe a recession was needed to bring the inflation to a halt. And no responsible policymaker wanted to be forced into eventual massive easing because of a delay in taking milder action.

However, Mr. Kimbrel said, precisely because the business, financial, and political communities watched the Committee's moves so closely, he felt that the decision to ease should come only when the Committee wished to give a signal that it was fully ready to move in that direction. It seemed to him that the markets would quickly become aware of even a slight move on the Committee's part. What impact such news would have on market psychology, he could only guess. But he was afraid it could have a rather significant impact on decisions of corporate and other borrowers who might interpret the policy move to mean that the Committee had shifted its objective from fighting inflation to avoiding recession. That interpretation was especially likely if the action came one day after the announcement of some rise in unemployment. Against that setting, the inflationary expectations which the Committee had been trying to reverse for only a relatively short time might very well flare up again. Therefore, while he had much sympathy with the proposition that the economic situation might demand a change in posture, he still thought the time had not yet come for such a move. His preference was for alternative A of the draft directives.

Mr. Francis said that, measured by every one of the standard monetary aggregates, the Federal Reserve System had been far tighter since early June--that is, in the last four months--than in the first five months of the year. Federal Reserve credit had been unchanged for four months after growing at a 6 per cent annual rate. Member bank reserves had declined at a 10 per cent rate after growing at a 3 per cent rate. The money stock had been about unchanged after growing at a 5 per cent rate. The demand deposit component of money had declined after growing quite rapidly. That was the story as judged by the figures available up to mid-August, as judged by the data as revised in August, and as judged by the data now in use. They all told the same story.

Mr. Francis agreed that some tightening in the summer, inadvertent or not, had been desirable. It was now evident that the limitations on expansion during the first five months of the year had been quite moderate. But the restrictions of the past four months had been severe and should not be continued. If there should be no increase in the money stock during the next three months, as there had not been in the last four, the rate of increase in total spending would probably experience such a decline that real production would decline unnecessarily and regrettably.

Mr. Francis remarked that the Committee already appeared to be getting a lagged effect from the rather limited monetary restriction of the first part of the year. The stagnation of employment, retail sales, construction, and industrial production in recent months reflected the slight monetary restraint early in the year. One might expect much more stringent lagged effects in the next six months from the greatly increased monetary tightness of the past four months. It was, of course, true that no firm sign of mitigation of the acceleration of price increases had become evident yet. But he thought one had to recognize not only that total spending lagged behind monetary actions by many months, but also that prices lagged behind spending by additional months. If the Committee waited to see price effects before moderating its policies, it would be contributing unnecessarily to undesirable gyrations in production and employment.

Accordingly, Mr. Francis thought it was imperative that the Desk be given instructions to take immediate steps to assure that in the next three months there would not be such severely restrictive trends of the strategic monetary aggregates as in the past four. More specifically, he suggested that the money stock should be increased at a 3 per cent annual rate in the next three months, in contrast with the no change of the past four months and with the 7 per cent rate of increase in 1967 and 1968. He believed it was necessary for the Committee to instruct the Desk to achieve easier conditions in the money market through the acquisition of enough securities to bring about the necessary change of trend in bank reserves, demand deposits, and money. It was regrettable that the Committee had been so restrictive as to permit the run-up of interest rates that had occurred in the past six weeks. But since it had, it was all the more important that the Committee be absolutely sure to achieve some easing now. In his judgment if the Committee failed to make a policy change now of the magnitude called for by alternative B of the draft directives, it would have cause to regret that failure at some point in the future.

Mr. Robertson then made the following statement:

> It seems to me we are living through one of those periods when it is particularly important for us to keep things in perspective--weighing events that have already occurred against future prospects, and considering not only the statistics of recorded actions but also the basic attitudes and expectations that are likely to mold the actions of the future.
>
> The information before us today contains increased signs of cooling tendencies in demands and resource use. Presumably some of this cooling is a result of tight credit conditions, with monetary aggregates being held down and interest rates being pressed up to very high levels. Because such monetary restraints can exercise a dampening influence on the economy for a substantial period into the future, it is right for us to be concerned about becoming too tight. We need to watch developments very carefully to be sure that our policy keeps

generating enough restraint to encourage a continued orderly cooling of the economy, but not so much as to precipitate a needlessly deep recession.

Our policy options are narrowed, however, by the tenaciousness of upward price and wage pressures and of widespread inflationary expectations. Until these attitudes begin to soften, we are handicapped by the risk that any letup of monetary pressures will set off a new inflationary surge.

I am hopeful that the kind of economic news we have heard this morning will soon begin to generate more sober appraisals of the future on the part of business, labor, and consumers. But, in the interim, I think our best policy choice is to hold money market conditions about where they are between now and our next meeting. I would want the Manager to be very careful not to let any sense of further tightening develop, but with that caveat I would vote for alternative A of the directive as drafted by the staff.

Mr. Robertson added that the modifications in the first paragraph suggested by Messrs. Hayes and Solomon were acceptable to him. In his judgment the System was at a critical stage right now; it was on the verge of accomplishing its objective. If it let up on monetary restraint too early--and just after the report of a 4 per cent unemployment rate--it would risk a renewed surge of inflationary expectations and do more harm than good.

Chairman Martin recalled that at the previous meeting he had suggested that the members carefully assess all of the factors bearing on the policy decision that would have to be made today, and it was evident from the go-around that they had done so. In developing his own assessment he had talked about the economic situation with a number of people in whose judgment he had a great deal of confidence. His conclusion was that the staff's analysis was excellent for the kinds of circumstances that had prevailed in 1965. He would have agreed completely with that analysis if those conditions still prevailed. However, with the upthrust in the economy since 1965 an inflationary psychology had emerged that was now the overriding element in the economic situation. Because of that psychology, he thought it would have been disastrous for the System to have moved toward ease in August of this year.

In general, Chairman Martin remarked, his views were quite close to those expressed by Mr. Bopp today. As the latter had indicated, the Committee's policy in the first half of 1969 had been less restrictive than intended. It was only recently that the desired degree of restraint had been achieved and it would be a mistake, in his (the Chairman's) judgment, to back off now. He was greatly disturbed by the number of businessmen who were thinking in terms of "the far side of the valley," and acting on the assumption that any slowdown in economic activity would be brief and mild. In that connection it was significant that the staff was currently estimating that GNP increased at a $17 billion annual rate in the third quarter, in contrast to earlier projections of a rise of $15 billion. As he had said at other recent meetings, there was a risk of succumbing to "statisticalitis."

He personally was convinced that this was not the time for a change in policy, the Chairman observed. He had a good deal of respect for the "monetarist" approach, and he had been interested in Mr. Francis' statement today; the consistent application of that approach had led Mr. Francis to advocate easing now and firming not too long ago. However, he (Chairman Martin) did not accept the monetarists' position regarding the critical importance of the specific rate of change in the money supply. In particular, he did not agree that the consequences of deviating significantly from some preferred rate for a period of time would be as disastrous as the monetarists believed.

The Chairman went on to say that with respect to the outlook for fiscal policy--a subject he probably was closer to than other members--he was more discouraged than he had been for some time. As he had said yesterday at hearings before the House Banking and Currency Committee, as far as he could see the public was not convinced that the President, or the Congress, or anyone else, was going to be effective in keeping expenditures under control. The proposed expenditures for the SST that Mr. Brimmer had cited illustrated the problem. Until there was some shift in that psychology, he thought monetary policy should stand up and be counted in the struggle against inflation.

As others had noted, Chairman Martin remarked, timing was always a problem in this area. Another problem was posed by the fact that the monetary policy in effect at a given time was not always the policy that had been intended. He would note that that worked both ways; in the summer of 1968, when the Committee had intended to make no change, the stance of policy--measured by the same aggregates as had been mentioned today--was easing; now the opposite situation prevailed. While one might wish that that were not the case, it was obviously necessary to accept the fact that many forces were always at work in financial markets.

The Chairman then noted that a majority of the members of the Committee appeared to favor alternative A for the second paragraph of the directive. He proposed that the Committee vote on a directive consisting of the staff's draft for the first paragraph, with the changes suggested by Messrs. Hayes and Solomon, and alternative A for the second paragraph.

Mr. Mitchell said he was not opposed to maintaining the prevailing degree of monetary restraint and therefore planned to vote favorably on the proposed directive. He noted that a number of members had indicated that they favored alternative A but would not want it to result in further tightening. He was not sure, however, to what extent the Manager would be able to take those views into account.

Mr. Maisel said he thought it would be useful to hear how the Manager would plan to operate if the Committee adopted alternative A.

Mr. Holmes said he might first note that the pattern of change in the various monetary aggregates in September had been such that if the Committee had adopted the directive language proposed by Mr. Mitchell at the previous meeting some firming of money market conditions would have been called for in the recent period. He then remarked that he would interpret the discussion today to mean that the Committee was prepared to accept the October bank credit projections which the blue book suggested would be consistent with the maintenance of prevailing conditions in money and short-term credit markets; in other words, that it would not want to have the proviso clause implemented in the direction of less firm conditions unless it appeared that bank credit was declining more than projected.

Mr. Maisel said that on that basis he planned to cast a dissenting vote on the directive.

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

> The information reviewed at this meeting suggests that the pace of expansion in real economic activity was sustained in the third quarter by an acceleration of inventory investment, which about offset a further slackening in growth of private final sales. Some monthly economic measures have weakened recently, and slower over-all growth is projected for the fourth quarter. Substantial upward pressures on prices and costs are persisting. Most market interest rates recently have

risen to new highs as demands for funds have pressed against limited supplies. In September, on average, the money supply changed little as U.S. Government deposits rose considerably further, and bank credit increased slightly after 2 months of substantial decline. The outstanding volume of large-denomination CD's decreased further in September, and flows of consumer-type time and savings funds at banks and nonbank thrift institutions appear to have remained relatively weak. The U.S. foreign trade surplus increased a little in August. In August and September the deficit in the over-all balance of payments on the liquidity basis was very large, although not as large as in preceding months; and the official settlements balance, which had been in surplus for more than a year, shifted into deficit, reflecting slackened Euro-dollar borrowing by U.S. banks and new speculative flows into Germany. Exchange market tensions were reduced somewhat when the German Government decided to cease temporarily official sales of marks, after which the exchange rate for that currency rose above the official parity. 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.

Mr. Hickman suggested that the staff be assigned the problem of examining the relationships between the behavior of the money supply and of Treasury balances at commercial banks. It seemed to him that the two series were inversely related in the short run, and that impression was one reason he was presently reluctant to see the money supply adopted as a target variable. What he had in mind could be accomplished in a relatively short paper.

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so. There had been further internal discussions at the New York Bank, and the Desk was prepared to move if so authorized by the Committee.

Mr. Robertson asked whether there was any need for the System to engage in lending of securities if the Treasury was going to authorize Federal agencies to do so.

Mr. Holmes replied that System participation would still serve a useful purpose because of limitations on the kinds of securities contained in the portfolios of the agencies he had mentioned.

In response to a further question by Mr. Robertson, Mr. Holmes said he would still recommend the form of the amendment to the continuing authority directive shown in the Secretariat's memorandum of September 8, 1969. As far as the "terms and conditions" for System lending were concerned, Mr. Scanlon had suggested certain minor modifications in the text attached to his (Mr. Holmes') memorandum of August 22, 1969. The modifications were of a non-substantive nature and he was sure they would be acceptable to the Committee.[1/]

1/ The suggested modifications were as follows: In Section I, par. 2, and in Section II, par. 2: . Loan contracts may be renewed only when, in the judgment of ~~Federal-Reserve-Bank-of-New York~~ THE LENDING BANK AND THE MANAGER OF THE SYSTEM OPEN MARKET ACCOUNT, circumstances exist which justify a renewal. . . .; in Section II, par. 3: The amounts of securities to be loaned will be subject to no fixed limits but will be determined by the LENDING Reserve Bank in consultation with the ~~Federal-Reserve-Bank-of-New York~~ MANAGER OF THE SYSTEM OPEN MARKET ACCOUNT; and in Section II, par. 4: The borrower will be required to DEPOSIT AND pledge collateral.

Mr. Coldwell said it was his understanding that the Committee was planning to authorize lending of securities on the basis of a finding that operations of that type were reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies, in light of Counsel's opinion that with such a finding the practice might be regarded as authorized under the incidental powers of the Federal Reserve Banks. However, as Mr. Scanlon had noted at the previous meeting, Counsel had also expressed the view that the practice would no longer be legally authorized "if and when it should develop that delays in deliveries of securities no longer constitute an obstacle to open market operations." He asked what procedures Mr. Holmes would recommend to insure that the practice of lending was discontinued if and when the latter situation had developed.

Mr. Holmes suggested that, if the Committee approved the recommended amendment to the continuing authority directive, it provide for a review of the underlying circumstances every six months or at some other regular interval.

Mr. Hackley concurred in Mr. Holmes' suggestion. Since the legal authority depended on a finding of necessity it would be desirable for the Committee to review the situation periodically and to amend the continuing authority directive to eliminate the authorization in question if and when it was determined no longer to be required.

There was general agreement that any authorization for lending Government securities from the System's portfolio should be reviewed at intervals of six months.

By unanimous vote, the continuing authority directive was amended by the addition of the following paragraph 3:

> In order to insure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

Chairman Martin then noted that a memorandum from the Secretariat concerning Committee meeting schedules had been distributed recently.[1/] As the memorandum indicated, the Federal Advisory Council had expressed willingness to change its regular meeting dates from the third Tuesdays and preceding Mondays of the months of February, May, September, and November to the first Fridays and preceding Thursdays of those months, beginning in 1970. The Board had concurred in the proposed change, and in response to

1/ A copy of this memorandum, dated September 29, 1969, and entitled "FOMC meeting schedules for 1970 and later years," has been placed in the Committee's files.

an inquiry from the Board's Secretary all twelve Reserve Banks had indicated that they had no objection. The change in the FAC meeting dates would, of course, free four additional Tuesdays during the year for possible meetings of the Committee.

The Chairman suggested that the members study the alternative possible schedules discussed in the Secretariat's memorandum and that the Committee plan on considering them at its next meeting.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 28, 1969, at 9:30 a.m.

Thereupon the meeting adjourned.

Robert C. Holland

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) October 6, 1969

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on October 7, 1969

FIRST PARAGRAPH

The information reviewed at this meeting suggests that the pace of expansion in real economic activity was sustained in the third quarter by an acceleration of inventory investment, which about offset a further slackening in growth of private final sales. Some monthly economic measures have weakened recently, and slower over-all growth is projected for the fourth quarter. Substantial upward pressures on prices and costs are persisting. Most market interest rates recently have risen to new highs as demands for funds have pressed against limited supplies. In September, on average, the money supply changed little as U.S. Government deposits rose considerably further, and bank credit increased slightly after 2 months of substantial decline. The outstanding volume of large-denomination CD's decreased further in September, and flows of consumer-type time and savings funds at banks and nonbank thrift institutions appear to have remained relatively weak. The U.S. foreign trade surplus increased a little in August. In August and September the deficit in the over-all balance of payments on the liquidity basis was very large, although not as large as in preceding months; and the official settlements balance, which had been in surplus for more than a year, shifted into deficit. After new speculative flows into Germany led the German central bank to suspend its sales of marks, the exchange rate for that currency rose above the official parity. 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.

Alternative B

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving somewhat less 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.