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, December 16, 1969, at 9:30 a.m.

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

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

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

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

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

Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Messrs. Keir and Wernick, Associate Advisers, 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. Lewis and Merritt, First Vice Presidents of the Federal Reserve Banks of St. Louis and San Francisco, respectively
Messrs. Eisenmenger, Parthemos, Taylor, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, and San Francisco, respectively
Mr. Hocter, Vice President, Federal Reserve Bank of Cleveland
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Davis, Adviser, Federal Reserve Bank of New York
Mr. Carlson, Assistant Vice President, Federal Reserve Bank of St. Louis
Mr. Sandberg, Securities Trading Officer, 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 November 25, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on November 25, 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 November 25 through December 10, 1969, and a supplemental report covering the period December 11 through 15, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports Mr. Coombs commented that the Treasury gold stock would be unchanged again this week, although the Stabilization Fund had taken in $200 million, increasing the total gold held in the Fund to roughly $1 billion. The $200 million was purchased from the Bank for International Settlements in a triangular deal that had been worked out at the last BIS meeting. Mr. Hayes and he previously had been approached by the Deputy Governor of the Bank of Spain who indicated that his Bank was interested in acquiring spot dollars against a forward gold sale. They replied that neither the Federal Reserve nor the Treasury undertook forward operations in gold, but volunteered to inquire whether the BIS might be interested. Under arrangements worked out at Basle, the Bank of Spain sold $200 million of gold forward to the BIS and the BIS sold spot an equivalent amount of gold to the U.S. Treasury. The dollars acquired by the BIS from the spot gold sale would be lent to the Bank of Spain.

Mr. Coombs added that the Treasury had financed the purchase of that gold by warehousing an additional $200 million of sterling with the System, increasing the total of such warehoused sterling to $500 million. He understood, however, that the Treasury might well monetize the SDR's that would be allocated to the United States in January. If they did, he would hope that they would use part of the free cash they obtained to unwind the warehousing operations.

Mr. Coombs noted that the free market price of gold had fallen to $35 flat last Tuesday (December 9) and was only slightly above that figure today. This morning the Treasury had announced that it was on the verge of an agreement with the South Africans with respect to an arrangement on marketing of gold. He would expect that South African gold sales plus very high Euro-dollar rates would continue to exert a depressing influence on the free market gold price.

The exchange markets had remained generally quiet, Mr. Coombs continued. There had been some easing of the guilder, enabling the Federal Reserve to pay down its guilder swap debt. Sterling had been generally holding even, although moderate inflows in the last few days had enabled the Bank of England to make a further payment of $50 million on the swap debt, thereby reducing the total outstanding to $650 million. In the case of the Swiss franc, there continued to be recurrent rumors of revaluation. It was now more or less common knowledge in Switzerland that, at the time the German mark was allowed to float last September, the Swiss

National Bank had recommended to the Swiss Government that the franc be revalued. That recommendation was rejected by the Swiss cabinet. However, the cabinet was now asking for legislation that would permit it to change the Swiss franc parity without the prior approval of the Swiss parliament.

Turning to the mark, Mr. Coombs said that questions were now being raised in the market as to whether the German Government, which was still faced with fairly strong wage pressures, might not have overdone the revaluation somewhat. He personally did not think so, but such questions were apparently inducing market operators to go short on the mark. As a result the leads and lags--which earlier had swung in Germany's favor--might now swing back in the other direction beyond dead center, and produce heavier and more protracted selling pressure on the mark than had previously been expected. Since the end of September the German Federal Bank had already lost $4 billion and would have lost another $1 billion in the absence of that amount of market forwards outstanding. The general view at the Federal Bank and elsewhere was that it might be possible to get through the end of the year without significant further losses, but that heavy outflows would resume in January.

In conclusion, Mr. Coombs referred to his observation at the last meeting of the Committee that the Common Market countries, in connection with the renewals this month of their swap lines with the System, might jointly urge a deletion of the revaluation clause in the swap agreements. The risk of such a development now seemed to have been avoided. He had indicated to each of the Common Market central banks at the last Basle meeting that the Committee would take a very strong stand against deletion of the revaluation clause. Some of those central banks might want to discuss the matter further in the future, but he would expect all of the swap arrangements maturing this month to be renewed on the present terms. The German and Belgian arrangements had already been renewed on that basis.

Mr. Brimmer noted that in the triangular transaction Mr. Coombs had described the System had, in effect, temporarily financed the Treasury's purchase of gold. He asked whether it was likely that the System would be expected to help finance any gold purchases the Treasury might make under the arrangements now being worked out with South Africa in the Rome negotiations.

Mr. Coombs replied that while he had not been close to those negotiations it was his impression that the Treasury would not have a problem of that kind under the proposals being discussed. Moreover, the Treasury could monetize some of the Stabilization Fund's gold holdings. He thought they would be well advised to do so in any case, since those holdings had been built up to the large figure of $1 billion.

Chairman Martin noted that Mr. Daane had been participating in the negotiations in Rome and would be in a position to report fully on them when he returned.

By unanimous vote, the System open market transactions in foreign currencies during the period November 25 through December 15, 1969, were approved, ratified, and confirmed.

Mr. Coombs observed that two System drawings would reach the end of their first three-month terms soon. These were a $175 million drawing on the Swiss National Bank maturing January 9, 1970, and a $40 million drawing on the Netherlands Bank maturing January 22. He would recommend renewal of both drawings for further three-month periods if necessary, although he hoped it would be possible to make substantial paydowns on the System's Swiss franc and guilder debt early in the new year.

Renewal for further periods of three months of the System swap drawings on the Swiss National Bank and the Netherlands Bank was noted without objection.

Mr. Coombs then commented that there was a continuing policy problem with respect to Bank of England repayment of swap debt owing to the System. As of the moment, actual and scheduled repayments of debt by the British since November 13, 1969, came to a total of $968 million, of which the Federal Reserve share was $269 million. That was a larger--but only somewhat larger--ratio of debt repayment than had been in prospect at the Committee's last meeting. In accordance with the Committee's instructions, he had continued to press the Bank of England to use any current receipts to pay down its debt on the swap line, which was now reduced to $650 million. The Bank of England might well take in a considerable amount of money during January and February and he was hopeful that the System would be able to get a fairly high percentage of those inflows. However, pressure from the continental European creditors might well necessitate a debt repayment of $120 million to them within the next month or so.

The major question of the moment, Mr. Coombs said, concerned the use the British Government was to make of $425 million of SDR's which it would be allotted on January 1. As he had noted at the preceding meeting of the Committee, Governor O'Brien had indicated at the November Basle meeting that the British planned to liquidate about $400 million of the overnight credits extended by the U.S. Treasury. Since then the British had put forward a new proposal, under which their $425 million of SDR's would in effect be divided between repayment of overnight credits to the Treasury and of swap debt to the Federal Reserve. However, a disproportionate share--$300 million--would go to the Treasury while only $125 million would be paid to the System.

Mr. Coombs said it was his personal reaction that the new proposal was still not good enough; he thought the System should receive at least $225 million of the $425 million available. As he had mentioned at the preceding Committee meeting, the Treasury apparently was not pressing for heavy repayments, and would be satisfied with repayments of no more than $25 million per month.

Mr. Coombs noted that one further aspect of British use of SDR's for debt repayment purposes had been clarified recently. None of the SDR's involved would have to be transferred or cashed in for dollars in order to effect the debt repayments, and the IMF would not be involved in any way. The operation would be a purely bookkeeping transaction in which SDR's were taken into the British reserves while an equivalent amount of dollars would be paid out of British reserves. At present the Bank of England was in a relatively comfortable cash position.

Mr. Coombs thought there was a good chance that the Bank of England would agree to make a repayment of $225 million rather than of $125 million if urged to do so by the System. A repayment of $225 million would bring their swap debt down to $425 million. There was a fair chance of getting further repayments from current receipts of another $200 million in January, which would leave a balance outstanding of $225 million at the end of that month. The British might then be within reasonable striking distance of cleaning up the whole debt within the first quarter. An announcement in, say, March that the Bank of England's swap debt to the System had been fully repaid would have a strengthening effect on the sterling market and would also help safeguard the reputation of the entire swap network.

Chairman Martin remarked that he had talked with Governor O'Brien about the subject when the latter had visited the United States shortly after the preceding Committee meeting. When Governor O'Brien had noted that the British planned to apply all of their SDR allocation to repayment of the U.S. Treasury's overnight credits, he (Chairman Martin) had suggested the desirability of using some part to pay down the debt to the Federal Reserve. Governor O'Brien had then proposed the plan Mr. Coombs had mentioned, of repaying $125 million to the System and $300 million to the Treasury. He (the Chairman) had indicated that while he could not speak for the Committee he personally would find such a plan acceptable.

Chairman Martin added that there was merit in Mr. Coombs' proposal that the British be pressed to make a larger repayment on the basis of their SDR allocation. From the longer-run point of view, however, he doubted that it would make a great deal of difference whether that repayment was $125 million or $225 million.

Mr. Hayes observed that during the past year or so a good deal of concern had been expressed in Committee discussions about the slowness of British repayments on their swap debt to the System. As had been noted on a number of occasions, the duration of the British debt had thrown a shadow on the idea that the swap network was intended to meet only short-term credit needs. Clearly, all of the members would like to see that debt repaid as soon as possible. Accordingly, he thought the Committee was indebted to the Special Manager for emphasizing the importance of repayment of the debt and for keeping a reasonable degree of pressure on the Bank of England to that end.

Mr. Mitchell said he thought it would be highly desirable to be able to announce in early 1970 that the Bank of England's swap debt to the System had been repaid in full. Accordingly, he would want to maintain pressure on the British to make repayments.

The Chairman concurred in the observations of Messrs. Hayes and Mitchell. He thought Mr. Coombs was moving in the right direction in trying to get the British swap debt cleared up.

Mr. Brimmer remarked that he shared the concern the Special Manager had expressed. Continuing, Mr. Brimmer said the fact that the U.S. Treasury was not pressing for rapid reductions in its overnight credits suggested the possibility of having the Treasury take over some of the System's credits to the British. As Mr. Hayes had noted, the System's swap network had been intended to deal only with short-term credit needs.

Mr. Sherrill agreed that it would be highly desirable to have the British swap debt cleared up by March, if possible. In his judgment, however, the British performance thus far had been excellent; they had reduced the outstanding balance faster than he had anticipated. Accordingly, he would not want to press them too hard in connection with future payments on the swap debt.

Chairman Martin remarked that he was certainly sympathetic with the British desire to clear up the Treasury's overnight credits.

Mr. Coldwell said he thought the Committee's primary concern was with repayment of the swap debt. He would support the Special Manager's position that the System should seek a substantial repayment when the SDR's were allocated.

Mr. Hickman expressed a similar view. He added that the System's swap network had been a highly successful undertaking but its future was now threatened by the fact that the British debt was running on for too long. It was very important to have the line cleared up, perhaps by the means Mr. Brimmer had suggested.

Chairman Martin then invited Mr. Brimmer to bring the Committee up to date on the status of the 1970 balance of payments program.

Mr. Brimmer noted that he had made rather pessimistic reports on the subject at the last two meetings of the Committee. To his pleasant surprise, however, late last week the President had approved a balance of payments program for 1970 that was much more rigorous than any one had expected. The voluntary credit restraint program was approved in precisely the form the Federal Reserve had proposed; the surprise lay in the action on the Department of Commerce program for controlling foreign direct investment. The program the President had approved was identical to that of 1969 except for an increase in the minimum allowables for underdeveloped countries from $1 million to $5 million.

As the Committee would recall, Mr. Brimmer continued, the Commerce Department originally had sought three types of liberalization in the 1969 program--eliminating the schedules dividing foreign areas into developing, developed, and intermediate countries, raising the minimum allowables generally, and increasing the proportion of retained earnings permitted. Under the Commerce proposals the target for direct investment outflows would have been raised from $3.5 billion in 1969 to $4.2 billion in 1970. Subsequently, as a result of Treasury objections, Commerce had been asked to submit alternative proposals not involving all three types of liberalization. On that basis, the 1970 target would have been in the neighborhood of $3.9 billion, with the specific amount depending upon the options Commerce chose. Under the proposal the President had now approved, the target was likely to be about $3.6 billion.

Mr. Brimmer added that the Commerce Department had asked that the announcement of the 1970 program be deferred for a few days. The announcement probably would be made sometime later this week.

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 November 25 through December 10, 1969, and a supplemental report covering the period December 11 through 15, 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:

> In the period since the Committee last met there was a further deterioration in the capital markets, while the three-month Treasury bill rate soared to a record level in a very shaky market. More recently, however, somewhat more stable conditions appeared to prevail, at least temporarily. As in the previous period, the major concern of the financial markets was the lack of conclusive evidence that anti-inflationary policies were really working, the worry that fiscal policy was going off the rails, and the consequent fear that the markets would be in for prolonged--and perhaps intensified--monetary restraint. With the dividend and tax dates now out of the way, some market observers are anticipating a modest rally in both the Treasury bill and the bond markets, although the year-end interest crediting period poses problems--perhaps serious ones--for the thrift institutions and perhaps the commercial banks as well. In any event, it would appear prudent to be prepared for a further erratic performance in the financial markets as they react to short-run supply-demand developments and various extraneous events. There is not much depth, breadth, or resiliency left, nor will there be until there is some fundamental change in the underlying economic situation.
>
> Interest rate developments have been covered in some detail in the written reports to the Committee and I will not dwell on them here. Corporate and municipal

bond yields both reached new highs, with underwriters under serious pressure. Indeed, the concern of most municipal underwriters appeared to be how to come in second in bidding for new issues so as to be in a position to acquire new bonds at a handsome concession once the winning syndicate had been broken. A relatively light calendar has eased the situation for the moment, but heavier volume looms ahead for January, and a substantial amount of short-term tax-exempt borrowing is slated over the next few weeks from States and municipalities that have not been able to meet their needs in the capital markets. Federal agency borrowing is scheduled to be somewhat less this month than it has been, but the housing agencies expect to be hard hit after the year end and are likely to step up their takings once again. In addition, a large volume of asset sales is scheduled by various agencies before the end of the fiscal year, and the Farmers' Home Administration--which has $2 billion or so to dispose of--has just announced a new program for accomplishing these sales through an underwriting syndicate. All in all, the capital markets still have a severe testing period ahead.

The three-month Treasury bill rate, as the blue book1/ notes, rose well above the 7-1/2 per cent upper limit of the range deemed likely at the last meeting of the Committee. Dealers have been caught with relatively heavy inventories at a time of declining prices and high financing costs, and it has not been a very happy time for them. In yesterday's weekly Treasury bill auction an average rate of 7.92 per cent was established for both three- and six-month bills, up 44 and down 11 basis points, respectively, from the averages established in the auction just prior to the last meeting of the Committee.

Open market operations over the period, in carrying out a policy of continued monetary restraint, had to be conducted flexibly in order not to exacerbate conditions in a very weak Treasury bill market. Generally speaking, marginal reserve measures and the Federal funds rate were little changed from levels prevailing recently, although special care was exercised to keep the Federal funds market free from strain at a

---

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

time when bill rates were under greatest upward pressure. Forces at work in the Treasury bill market were too strong to be counteracted by System action without jeopardizing reserve objectives and without throwing off false signals that the System was pulling back from its posture of restraint. Thus, no all-out action was undertaken to prevent the bill rate from rising above the 7-1/2 per cent range considered likely at the time of the last meeting. Foreign official accounts had heavy transactions over the period, and open market operations were utilized to mitigate their impact on the Treasury bill market. Thus early, and again late, in the period the System sold short-dated bills to foreign accounts, making room for market purchases of longer-dated bills in heavy supply in the market. In between, the System bought bills offered by foreign accounts in order to keep them out of the market, but offset any unwanted reserve impact by letting Treasury bills run off at maturity or by responding to unsolicited dealer bids for short-dated bills which were in relatively scarce market supply. While the System portfolio showed only a modest change over the period--a decline of about $125 million--the total volume of transactions was relatively large. Outright purchases totaled well over $1 billion, as did outright sales and redemptions taken together. And, while we preferred to buy as many bills in the market as we could, the sizable need to absorb reserves in the statement week ahead led to an extensive use of repurchase agreements--totaling nearly $2 billion--in order to provide reserves on a temporary basis only.

Looking ahead, as the blue book notes, a substantial reserve absorbing job will have to be done over the next two weeks, perhaps on the order of $800 million; this could turn out to be a sensitive job. Some part of the reserve absorption, however, was accomplished yesterday as the System ran off $198.5 million of its holdings of Treasury bills maturing this coming Thursday. In addition, it may prove desirable to use matched sale-purchase agreements fairly extensively--taking reserves out of the market on a temporary basis--in view of the anticipated turn-around in the reserve outlook for early January. If the Treasury does monetize SDR's and some part of the $1 billion in gold held in the Stabilization Fund, we will have to offset whatever reserve impact may occur.

As far as the monetary aggregates are concerned, the credit proxy grew at a rapid 11 per cent annual rate in November and is expected, at this moment, to show no further growth this month, although a modest increase--at about a 1 per cent rate--is expected by our projectors if other nondeposit liabilities are included. This is at about the lower end of the range expected at the time of the last meeting. Money supply, as the blue book notes, is now expected to decline at a rate within a 3 to 6 per cent range, a greater decline than had been expected at the time of the last meeting. I should note, however, that New York Bank projections anticipate only a 1 per cent rate of decline. The projections--as usual--are subject to considerable revision, and unless the Committee feels otherwise I would not plan to implement the proviso clause unless there are substantial deviations from the blue book projections. I would assume that the Committee would not object to seeing some further growth in the aggregates if that should happen to occur without special stimulus from System operations.

I should note that the Desk has gained some further experience with the lending of securities, although the volume of operations remains modest and some of the dealers have been slow to experiment with the new facility. At the peak $85 million in loans were outstanding, but the volume at the close of business yesterday was back to $14 million. We have had meetings with the dealers on various technical aspects of the lending operations and we may have some minor changes in procedures to propose in the near future.

I should also add that it is expected--now that all the necessary approvals have been received--that the System Open Market Account will be converted to book-entry on or about January 2. In this connection arrangements are being made to put transactions for the System Open Market Account through the clearing arrangement in effect at the Federal Reserve Bank of New York. This would represent a modest further step in streamlining procedures for the delivery of securities in the Government securities market.

Mr. Mitchell observed that total time and savings deposits were projected in the blue book to increase at a 3 to 6 per cent annual rate in December and to decline at a 2 to 5 per cent rate in January, while the money stock was projected to decline at a 3 to 6 per cent rate in December and to be about unchanged in January. He wondered whether those projections implied a change in the Desk's operations from December to January.

Mr. Holmes replied that the projections assumed an even keel would be maintained over the whole period with respect to such money market variables as net borrowed reserves, member bank borrowings, and the Federal funds rate. However, market factors would be supplying a large volume of reserves prior to the year end and absorbing reserves subsequently, and the Desk would have to engage in large offsetting operations to maintain steady money market conditions.

Mr. Hickman commented that under the Committee's instructions to the Manager it was the monetary aggregates which were allowed to fluctuate rather than money market conditions. His own preference would be to reverse that order of priorities.

Mr. Mitchell then asked whether the substantial withdrawals of time and savings deposits expected around the year end were likely to be associated with an expansion of private demand deposits.

Mr. Holmes replied that on the basis of last year's experience some temporary growth in demand deposits could be expected around the year end, as was pointed out in the blue book.[1/] He thought it was also possible that there might be some easing in short-term interest rates at that time.

In response to a question by Mr. Hickman, Mr. Partee observed that the projected weakening in the performance of total member bank deposits from December to January was directly related to the expectation of sizable outflows of time and savings deposits after the year end. Those outflows also were expected to bolster demand deposits somewhat, and that helped to account for the projection of little change in the money stock in January following an anticipated decline in December.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 25 through December 15, 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.

1/ The blue book passage referred to read as follows: "... year-end window dressing by domestic non-financial corporations seeking to conform to Commerce regulations on direct foreign investment might lead to a temporary inflow of funds and a bulge in year-end demand deposits similar to the one that occurred last year. Such a development would tend temporarily to strengthen money supply performance at year-end and in early January, as also might shifts of savings from institutions to the market."

Mr. Wernick made the following statement concerning economic developments:

As we enter the new year, the latest evidence as to the performance of the economy strongly suggests that monetary and fiscal policies have been taking hold and weakness in the economy is becoming more pronounced. Key indicators, which earlier were in apparent conflict with the easing trend shown in the aggregate data, now are slowing or actually moving downward. If these trends continue into December, as seems highly likely, I believe that real GNP growth may well come to a complete halt in this final quarter of 1969, one quarter earlier than indicated in the staff projections.

The fourth consecutive monthly decline in industrial production in November is convincing evidence to me that weakening sales in the face of large and growing inventories, especially in consumer durable goods lines, is resulting in production adjustments. While about half of the November decline in the index was due to the G.E. strike, output schedules in auto plants were cut back sharply in November and even more severely this month to an annual rate of about 7 million cars. Moreover, the reduced rate of auto output has begun to be reflected in the operations of most auto supplying industries. Output of furniture and of other consumer goods also has been reduced and is likely to decline further. Outside the consumer sector, a larger part of current production, especially in industrial materials, appears to have been going into inventories rather than into consumption. All this points to the fifth successive month of decline in the production index in December.

Declining industrial output has also led to adjustments in work forces. Gains in manufacturing employment slowed after midyear and in November employment was reduced, even after taking account of the G.E. strike. In line with output and employment trends, unemployment compensation claims--a reliable economic indicator--have been rising. The rise has come earlier and has been larger than in the comparable period in 1966. Moreover, in late November and early December the rise in new claims for unemployment benefits apparently accelerated. In this context of an easing labor market, the significance of the drop in the unemployment rate in November seems questionable--the probabilities are that the unemployment rate will go up again this month.

Retail sales in recent months have continued to lack any sign of ebullience, due in part to the rather sharp slowing in payrolls over the past three months. Both weekly sales statistics and trade reports indicate that pre-Christmas sales have been disappointing, and are showing very little increase over reduced sales levels of a year ago. Auto sales have fallen since early November and in early December car sales were down almost 10 per cent from a year ago. The jump recorded in book value of business inventories in October, following sharp increases in the third quarter, was another reflection of the growing imbalance between sales and output. The ratio of durable goods inventories to unfilled orders increased further to a level appreciably above the 1966 high.

In view of the cumulation of negative factors, it seems certain that GNP growth will be markedly slower this quarter than last. The only question is how much. With auto and other retail sales reports now coming in weaker than anticipated, the rise in consumer expenditures that we have projected for the fourth quarter may well be overstated. The Commerce people tell us that they think the inventory valuation adjustment will be larger and the build-up in auto stocks somewhat smaller than we thought, so that our projection of the change in inventory in GNP terms may also be too high. Estimating quarterly inventory changes based on very limited data, however, is hazardous and the current period is no exception. But based on these adjustments, it now seems that the rise in dollar GNP this quarter could be as low as $10 billion, only a little more than half the third-quarter rate of over $18 billion and about $2 billion below the current green book[1/] projection. If so, real growth would come to a standstill this quarter.

Turning now to next year: In view of prevailing monetary tightness and the marked slowing in economic activity which appears to be gaining momentum, a period of decline in output in real terms is a likely prospect. But the extent and duration of the adjustment has become

---

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

more conjectural because of recent Congressional actions on tax revenues and expenditures which do not augur well for fiscal restraint. Clearly, the present scarcity of available mortgage funds and extremely high interest rates suggest that the only question is how much further housing starts will fall--our estimate of a decline to one million units by midyear is certainly in the ball park. Lack of availability of financing is also hitting hard at capital expenditures of State and local governments, and such outlays are likely to moderate significantly next year.

Given the compelling influence of prospective market forces--weakening demands, declines in profits, costly interest charges in the face of higher inventories and declines in output--it is increasingly doubtful that capital spending plans will be fully realized, especially in the manufacturing industries. In fact, a close examination of the Commerce-SEC data shows that manufacturers reduced capital spending plans between August and November and they plan to spend less on plant and equipment in the first half of next year than appears to be implied in the earlier private surveys. It is mainly the expanded plans in the utilities and communications industries, whose anticipations are not likely to be affected by easing product markets, which largely accounted for the additional strength indicated in the Commerce-SEC survey.

In the consumer sector, the latest readings of retail sales, the dramatic drop in consumer confidence shown in recent surveys, and the easing in personal income all point to continued sluggish outlays early next year. However, the usual difficulties in forecasting consumption are now compounded by the uncertain prospective additions to disposable income because of recent fiscal actions. The Senate tax reform bill, as it now stands, raises the specter of a substantial rebound in consumer expenditures sometime next year and a resurgence of inflationary expectations. Final judgments will, of course, have to await Conference Committee compromises or a possible Presidential veto.

On balance, it is clear that policy has made substantial progress toward assuring a less exuberant economic environment and one which holds promise of a moderation in currently pervasive cost and price pressures. I would interpret the apparent growing weakness in demands for goods and services as substantial

> evidence that a turnaround in the economy is under way and that an accumulation of downward tendencies, as we move into the new year, cannot be ruled out. These developments would seem to suggest the need for some easing in monetary policy, given the severity of current monetary restraints and the relatively long and uncertain lags with which policy works. My only hesitancy in suggesting such a change now stems from the expansionary potential of fiscal policy. It is probably more prudent to maintain conditions about as they are until next month, when we will have much more definite information for evaluating the potential impact of Federal budget expenditures and revenues on the economy in 1970.

Mr. Hickman observed that the maintenance of steady money market conditions had resulted in major gyrations in the money, credit, and reserve aggregates and on balance had led to a very restrictive policy. He asked whether Mr. Wernick had meant to imply that the Committee should hold to that course until the next meeting.

Mr. Wernick replied that the stimulative impact of fiscal legislation could be quite large. Since there was no current basis for making firm forecasts of economic developments in coming quarters until the nature of the legislation was clear, he had concluded that it would be advisable to continue the current policy until the next meeting.

Mr. Hickman expressed the view that a highly stimulative fiscal policy package was not likely to emerge from the House-Senate Conference, and that if such a bill did materialize, it would be vetoed by the President.

Mr. Partee made the following statement concerning financial developments:

Practically all of the signals being given off by the nonfinancial economy suggest that interest rates should be in a rather convincing downtrend by now. As Mr. Wernick has pointed out, indications of current and developing weaknesses in the economy are widespread; indeed, it may turn out that we are in a mini-recession right now without knowing it. In normal times, financial markets would be reacting to and extrapolating the shift in business trend, and would shrug off such developments as the sharp drop in the November unemployment rate as a statistical aberration and the latest business capital spending survey as the last fling of a notably lagging economic series. Thus, in both 1966 and 1960 the downturn in interest rates anticipated the subsequent business adjustment and in 1957 the shift in interest rate trend was about coincident with that in the economy.

These, however, are not normal times. Prices are continuing to rise at a rapid rate, and the forces making for further inflation appear impressively strong. The fiscal outlook is in a state of disarray, with all of the questions to be resolved concerned with how much more stimulative fiscal policy will become. Market expectations also have been affected by public statements from a variety of sources indicating the need for continued tight money conditions for some time to come, though it should be noted that signals of an easing in policy seldom have preceded a market-generated decline in rates. Finally, there is general awareness of a storing up of credit demands in many sectors, giving the impression of long queues of borrowers at the banks and in the market who will step forward when any leeway develops to take them on. Under these conditions, interest rates not only have failed to respond to the signs of business weakness, but have escalated to new highs. The rebound in yields from late October lows, evident in both short- and long-term markets, has ranged between 50 and 100 basis points.

This sharp recent rise in interest rates has not reflected any further tightening in monetary policy. Rates and conditions in the very short-term money markets have remained about unchanged, as reported in the blue book, and the monetary aggregates in November--when most of the interest rate increase occurred--were stronger than for some time past. Money supply rose significantly for the first time since late last spring, and the rebound in member bank deposits erased the October decline. Total bank credit on a month-end basis also rose substantially during November, reflecting in large part Treasury and other security financing and the need of both bank and non-bank dealers to hold larger inventories of unsold bonds.

But neither does the upward adjustment in yields appear to result from any upsurge in the over-all volume of private nonfinancial borrowing. Business loan expansion at the banks in November was quite modest, even allowing for loan sales to affiliates. New private security offerings, though higher than in preceding months, were only $200 million above the monthly average for the year. The rather more comfortable tone of the commercial paper market in recent weeks suggests that there may have been an easing off in the issuance of new paper, not only by banks but by other borrowers as well. And the volume of mortgages being generated now is almost certainly in a steep decline.

Rather than reflecting any special recent developments in the supply or demand for funds, it seems to me that the run-up in yields has mainly been the product of a shift in market psychology, coming in the context of the cumulative effects of the squeeze on institutional and borrower liquidity positions. Disappointment that the October rally did not carry through, nervousness as to whether the business outlook is really weakening sufficiently to help very much, concern about the crowded calendar of Federal agency issues and asset sales, and changing evaluations of the prospects for fiscal and monetary policy were all factors in the shift of sentiment. But market sentiment is by nature changeable, and I think that a change for the better is near. The worst of the fiscal news is probably behind us, as the Senate version of the tax bill is compromised down and the Administration stiffens its back against inordinate expenditure increases. And the weight of evidence in the direction of a relatively weak near-term business outlook is now accumulating rapidly and may soon become a major market factor.

Meanwhile, the very high levels to which interest rates have risen pose special problems for the management of monetary policy. Market yields are now so high that there can be very little doubt as to the year-end outlook for deposit intermediaries, assuming no change in ceiling rates. October deposit losses were exceptional for an off-quarter interest crediting period, and the recovery of savings flows in November and early December has been well below normal expectations. California savings and loans, in fact, are estimated to have lost nearly $100 million in the first 10 days of December, and consumer-type deposits at the weekly reporting banks have declined steadily throughout recent weeks.

There is simply no reliable way to estimate how unfavorable the year-end experience may be, since we have no feel as to the interest sensitivity of the remaining depositors. In July, when market rates were lower, however, savings and loans lost $1.5 billion and mutual savings banks $500 million over the interest crediting period, while consumer-type accounts at member banks declined $1.9 billion over the full month of July. A repetition of outflows of this magnitude in the weeks to come would imply a great deal of market churning, as the public bought market instruments and institutions (including the Federal Home Loan Banks) dumped liquid assets in volume into the market. Since the over-all liquidity position of financial institutions is considerably more strained than at mid-year, scattered instances of real distress, in banks as well as non-banks, could readily develop.

A second and perhaps even more important problem is that interest rate movements are likely to become a more unreliable guide in the day-to-day conduct and evaluation of policy. With yields at or close to their cyclical peaks, substantial short-run instability is to be expected as investors and borrowers react to every ebb and flow in the anticipatory tide. And if business is really in process of turning down, the old problem of relating rates to credit flows really comes to the fore. Even if interest rates begin to decline for only expectational reasons, any persistent effort to resist that movement would mean less Federal Reserve credit, and less monetary expansion, than the Committee had expected and than had been postulated in the blue book.

It would seem particularly important to avoid any such inadvertent monetary contraction in this kind of environment. Indeed, there already has been some modest tendency for the monetary aggregates to fade. The revised money supply figures for both October and November are about two percentage points weaker than had been estimated earlier, for example, and the Board staff projection for December has been reduced three percentage points from the figure projected at the time of the last Committee meeting. The problem of unexpected changes in rate and flow relationships is covered by the proviso clause in terms of the credit proxy. Nevertheless, I would emphasize that it will bear very careful watching in the period ahead.

Given the confused fiscal outlook, I cannot in good conscience recommend an overt easing in monetary policy today, even though I believe the business situation fully warrants a backing off from the current severe posture of restraint. The status of the tax bill, and probably the outlook for expenditures as well, should be clarified within a few weeks, so that the Committee will be in a considerably better position to evaluate the probable effects of a change in policy at its January meeting. Meanwhile, however, I would propose that the Manager be instructed to accommodate any downward tendency in yields that may develop in the market, just as he has accepted the increases of recent weeks. In addition, we should be especially alert to any unexpected weakness in bank credit and money, and activate the proviso clause promptly if this occurs. Finally, I would not be averse to seeing somewhat more reserves provided than now contemplated if liquidity pressures develop, especially in connection with heavy year-end deposit losses at the institutions. In old fashioned terms, I guess that my preference would be for the Manager to resolve doubts on the side of ease if there is occasion for doing so.

Mr. Mitchell asked whether the Manager could clarify his earlier comments regarding implementation of the proviso clause in light of Mr. Partee's concluding remarks.

Mr. Holmes said he had meant to suggest that it would be undesirable to begin modifying operations immediately on the first indication that the proxy was deviating from the projection. Given the uncertainties in the estimates of the proxy and the size of the revisions often made, there was much to be said for waiting for some confirmation of an apparent deviation before reacting.

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

> We international types have had few opportunities in recent years to present cheerful reports to the Committee. This being the last meeting of 1969, I propose to comment today on the improvements that have taken place this year both in the structure of the international monetary system and in the behavior of the major countries that are so important to the functioning of that system. I believe that 1969 will be looked upon by historians as a year of decision in the international monetary sphere--a year of decision in the sense that what happened in 1969 had a great influence on the future course of history. I am particularly anxious to set this on the record today because I shall probably miss the January meeting of the Committee and what I am about to say should be said in Chairman Martin's presence, since he had so much to do over the years with the developments that culminated in the historic events of 1969.
>
> The three major developments in the international monetary system in 1969 were (1) the coming into being of Special Drawing Rights in substantial amounts, (2) the drop in the free market price of gold, signaling the success of the two-tier system, and (3) the disappearance of the idea that exchange rates of major countries should remain fixed. I should like to comment on each of these developments from the viewpoint of their historical significance as well as their implications for the United States.

The inaguration of Special Drawing Rights, not in token amounts but in a volume that will equal one-fourth of official gold reserves after only three years, marks a turning point in international monetary history comparable to the significance, within a country, of the establishment of a central bank. It is now recognized that international money will not manage itself. Instead of relying on gold and U.S. balance of payments deficits, the world will now rely on the deliberate and systematic creation of international reserves.

A corollary is that the importance of gold will diminish--not in the sense that gold will be demonetized, which has no practical meaning as long as gold comprises a substantial fraction of official reserves--but in the sense that the stability and health of the international monetary system will not be dependent on the volume of gold production, the Russian wheat harvest, or the whims of speculators in commodity gold. The recent drop in the free market price of gold reflects, in part, a realization by those who operate in the gold market that the combination of the two-tier system and the activation of SDR's in substantial amounts marks a turning point in the reliance of the system on gold. I might add that I believe that the reported near-agreement with South Africa will strengthen the two-tier system.

If the establishment of Special Drawing Rights represents a step toward the management of international money, it also has implications for the balance of payments behavior of the United States. The willingness of other countries to go along with SDR's reflects not only a desire to be less dependent on gold but also, let us face it, a desire to be less dependent on the vagaries of the U.S. balance of payments for the supply of reserves to them. Thus, along with the benefits the United States can expect from the establishment of SDR's, it must recognize that the scope for incurring large balance of payments deficits is reduced. This doesn't mean a zero deficit on the official settlements basis year in and year out. Fluctuations must be expected and the system is resilient enough to absorb sizable fluctuations. But taking one year with another, the United States should probably aim in the years ahead for an average deficit on official settlements that does not exceed something in the order of, say, $1 billion. Whatever the particular magnitude of the U.S. deficit that is tolerable over time, the main point is that the United States will need to have a balance of payments policy; that is, we shall have more need to use economic policy instruments, and to persuade other countries to use policy instruments, that make it possible for us to keep our balance of payments within bounds.

This brings me to the third major development of 1969--the change in attitude toward using the exchange rate as an economic policy instrument. It was in 1969 that the British devaluation belatedly bore fruit in a startling betterment in Britain's balance of payments. It has been shown that exchange rate adjustment, once it is coupled with effective domestic policies, can shift resources to or from the foreign sector. Hopefully, the French and German experience will provide further confirmation for this proposition.

The very fact that three major countries adjusted their exchange rates in a two-year time span has dispelled the idea, which was current earlier in the 1960's, that exchange rates should remain absolutely fixed, at least for major countries. It is now rather widely accepted that, as long as sovereign nations have independent fiscal and monetary policies and differential rates of productivity growth, and as long as they are unwilling to extend unlimited credit to each other, exchange rates will need occasional adjustment.

All this being quite generally accepted, the debate at the moment is over the less important question of how and when exchange rates should be changed when they need to be changed--whether in smaller and more frequent steps or, as in the past, in large occasional steps. As you know, this entire question is now under study in the International Monetary Fund.

As far as the United States is concerned, the role played by the dollar forces us to be passive, though not necessarily silent, in exchange rate policy. Since there are many reasons why the gold value of the dollar should stay where it is, our exchange rate against other currencies can be changed only as a result of decisions by other countries to change their exchange rates against the dollar. The United States has an obvious interest in trying to assure itself that the accepted procedures for exchange rate adjustment will not contain a bias toward devaluation of other currencies against the dollar. This point takes on particular significance in light of our need, to which I referred earlier, to control the

U.S. balance of payments over time. For these reasons, the recent revaluation of the German mark was an event of great importance, not mainly because of its immediate benefits to the U.S. trade balance, which will not be large, but because it is an important precedent. Unless countries in structural surplus are willing to revalue early in the game, those in deficit will be forced to devalue, and this could leave the U.S. dollar high and dry in terms of competitiveness.

One of the delicate problems we face at the moment is to convince other countries that the U.S. interest in a better regime of exchange rate adjustment is not motivated by a wish to find an escape from the consequences of inflation in the United States. The best way to persuade them of this is to persevere with a sustainable program of fiscal and monetary restraint designed to stop the inflation.

Mr. Brimmer asked Mr. Solomon to elaborate on his comment that the near-agreement on gold with South Africa would strengthen the two-tier system.

Mr. Solomon replied that he did not know the precise details of the negotiations in Rome and had based his comment on a number of general considerations. First, if South Africa accepted an agreement with the United States of the type that press reports indicated was contemplated, that would imply an intention on the part of that country to accommodate itself to the two-tier system. Secondly, the achievement of such an agreement would increase the likelihood that other nations would continue to cooperate in adhering to the two-tier system. Finally, he would not expect any aspect of the agreement to undermine the two-tier system. Most likely the agreement would provide mainly that, if and when the free-market price of gold fell below $35, the IMF would be prepared to buy a limited amount of gold from South Africa if necessary for balance of payments purposes of that country.

Mr. Hickman noted that Mr. Solomon had called for "a sustainable program of fiscal and monetary restraint designed to stop inflation." Considering the outlook for reduced fiscal restraint and the emergence of a budgetary deficit as 1970 progressed, how would Mr. Solomon describe a sustainable monetary policy?

Mr. Solomon recalled that in commenting to the Committee in August about the stance of monetary policy in relation to balance of payments needs, he had expressed concern about the rate at which the monetary aggregates were contracting. He had thought then that a continuation of such contractions might result in the need for a sharp move toward ease, and accordingly he had urged some modification of policy. Subsequently, the aggregates had leveled off and some had even risen a bit. He therefore no longer felt the concern he had expressed in August. At the moment, his policy views were similar to those expressed by Messrs. Wernick and Partee.

Mr. Hickman noted that the leveling off of the aggregates had been fortuitous in the sense that the Committee had not instructed the Desk to achieve that result.

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:

> It seems to me that since our last meeting there have been no economic or credit developments significant enough to warrant any change of policy at this time. Despite the large decline in the production index, heavily influenced by the effect of strikes, a majority of the limited data which have become available in the past three weeks seem to me to be on the stronger side. Thus, they provide some balance to the predominantly weaker readings we were looking at last time. On the basis of data for the past two or three months together, the economy does seem to be rising at a distinctly slower pace than it was earlier in the year. But I think there are real grounds for doubt whether the slowing will be big enough or long-lasting enough to bring a significant braking of inflation. For one thing, business capital spending plans continue to be upgraded and show surprising signs of strength. Of even more importance is the prospect that fiscal policy is likely to swing sharply away from restraint after the new year begins. The President's threat of a veto was an encouraging sign of the Administration's determination to persist in the anti-inflation battle. Nevertheless, the exercise of such a veto would probably be at the expense of the six-month extension of the surtax at 5 per cent and of the investment tax credit repeal. Not only does the projected Federal budget surplus for fiscal 1970 appear to be in deep jeopardy, but the proposed full expiration of the surtax in June, together with an upward trend of social spending, would almost assure a substantial deficit in fiscal 1971.
>
> Recently, I have been struck by the growing skepticism of business leaders in our area on the likelihood of success in checking inflation through the use of monetary and fiscal policy. Some are inclined to draw the conclusion that inflation is inevitable; but there are a growing number who seem to be looking toward the possibility of wage and price controls as the only answer. For my own part, I would certainly shy away from any such extreme solution at this time, but I do believe that a new Government campaign to focus public attention on the inflationary consequences of excessive wage settlements might be useful in the present setting.

On the balance of payments front, there was a marked improvement in November on an underlying liquidity basis, with the reversal of earlier capital outflows to Germany probably a major factor. A renewed surge in Euro-dollar takings by American banks has again left its mark on the official settlements balance. But despite these temporary favorable developments and the generally favorable state of the gold and exchange markets, our international position remains very unsatisfactory in the light of the tenuous basis of our official settlements surplus and above all the weakness of our merchandise balance.

While the monetary aggregates were a bit stronger in November, their growth since midyear has generally remained quite modest--perhaps more modest than would be desirable over the long run. However, as I have said at previous meetings, I do not find this disturbing in view of the excessive growth in earlier periods and the stubbornness of inflationary pressures in the economy. We must recognize, on the other hand, that financial markets remain under very great pressure and that there is a good deal of apprehension regarding the possibility of large outflows from the thrift institutions after the crediting of year-end interest.

I can see no alternative to maintaining the present degree of monetary restraint, since the risks on the inflation side still clearly outweigh those on the side of recession. I would suggest the same marginal reserve targets agreed upon at the last meeting. In the light of subsequent market developments, however, the bill rate might be expected to vary, say, between 7-1/2 per cent and 8 per cent, although a movement below 7-1/2 per cent might well occur after the current seasonal pressures subside. Alternative A of the draft directives[1/] appears appropriate including the usual two-way proviso, but I would not like to see the proviso invoked unless developments differ rather widely from the projections. I would also agree that operations should be modified if unusual liquidity pressures should develop, although I believe that even without this explicit language the Manager has ample leeway to deal with any special problems that may arise.

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

> For some months now it has seemed to me that the time was getting increasingly ripe for some modification in the Regulation Q ceilings, especially those on large-denomination CD's. I would still think that some easing of these ceilings might be considered concurrently with implementation of the recent proposal with respect to bank-related commercial paper. A modification of Regulation Q would go far to counter the growing foreign criticism of American monetary policy as having too concentrated an effect in the Euro-dollar market. A modest change in the Regulation Q ceilings for savings and other types of time deposits might also be worth considering on grounds of equity.

Mr. Lewis commented that the monetary restraint of the past twelve months was showing results. Total spending was now probably down to a 5 per cent annual rate of growth and real product was likely not growing at all. Considering the lag with which monetary restraint operated, the recent moderation in activity probably reflected, in the main, monetary actions of the first half of this year. The more restrictive monetary developments of the past six months would probably have their major effects in early 1970.

Mr. Lewis noted that the money stock had been at a slightly increased level in the past four weeks, but was projected by the Board's staff to decline in December. In order not to force the economy into a recession greater than was necessary to attain needed price effects, he believed that a moderate rate of growth in the money stock should be permitted. To permit no growth or a decline would lead to a serious decline in real product, according to the estimates of the St. Louis Reserve Bank. He would prefer to see a policy of moderate restraint maintained for a long time, rather than a continuation of extreme tightness and the attendant risk of subsequent relaxation, as in 1967.

Mr. Kimbrel reported that the same uncertainties about the current state of the economy and the appropriate policy position that prevailed nationally also prevailed in the Sixth District. At the meeting of the Atlanta Bank's board of directors last Friday, the discussion suggested that there were more doubts that inflationary conditions would continue indefinitely than there had been for a long time. Visiting Branch board members from the Birmingham, Jacksonville, Nashville, and New Orleans zones uniformly reported that the members of their respective boards were finding an increasing number of persons in their areas who were gaining the impression that there was a slowing down in economic activity.

For one thing, Mr. Kimbrel said, businessmen were finding the labor market somewhat easier, judging by the increasing number of applications for employment. Their impressions that the consumer market was becoming less ebullient were confirmed by the results of an informal survey the Bank's Research Department had made of the sales experience of department stores in the District's leading cities. December sales experience so far had been disappointing, and department store executives were pessimistic about the sales outlook for next spring.

Nevertheless, it seemed to Mr. Kimbrel that, by and large, the change in sentiment was based more upon growing apprehension about the future than upon concrete evidence about the present. The Atlanta Bank's directors could come up with few specific cases of cutbacks in planned capital expenditures with which to back up their general impression that such plans were being curtailed.

The most that could be said of what the economic data were showing in respect to a slowdown, Mr. Kimbrel continued, was that, in general, the rate of advance was lower now than it had been earlier this year. Total nonfarm employment and payrolls in the District increased in October on a seasonally adjusted basis, and unemployment was at a 3.6 per cent rate. Because of unfavorable weather early in the growing season, farm income this year would probably be down from 1968, and in some areas of the District loan refinancing problems were developing. Construction employment remained high--it was up about 5 per cent from a year ago--and contracts continued strong in October even though decreased new savings flows to District savings and loan association raised doubts about the future of residential construction. Residential construction had been holding up better in the District than nationally, especially in Florida.

What emerged so far as the District was concerned, Mr. Kimbrel said, was a picture of a vigorous economy continuing to operate at a high level but with a slowing down toward a more sustainable rate of growth. In general, that seemed to be typical of the nation as a whole. That condition was, he believed, what the Committee would like to happen. The Committee could not, of course, be certain that that trend toward a more sustainable rate of growth would not change toward a major downturn unless policy was relaxed. There were valid arguments supporting those who saw that danger. Nevertheless, it seemed to him that the danger was greater that a move toward relaxation at this time could quickly eliminate any progress that had been made. Inflationary expectations that had only begun to diminish--if at all--had been increased by the current uncertainties about the fiscal picture.

Mr. Kimbrel thought it might well be that the distortions that were occurring in the money markets because of the System's heavy reliance upon Regulation Q might pose the greater danger. Undoubtedly, the Board was considering carefully the various means that might be employed to get out of the present difficulty without moving toward general credit relaxation. One possibility, of course, would be to remove the ceiling on very large CD's while at the same time imposing special reserve requirements, a move similar to the treatment of Euro-dollar borrowing.

Under present circumstances, Mr. Kimbrel concluded, if he had a choice he would favor alternative A for the directive.

Mr. Bopp remarked that expectations continued to be a critical ingredient of policy deliberations. Unfortunately, nothing had happened since the last meeting to alter his conviction that expectations were predominantly bullish. In fact, some recent developments might have encouraged the bulls about the durability of inflation.

One such development, Mr. Bopp continued, was the decline in the unemployment rate in November. Apparently, that was largely the result of a drop in the number of women and young people seeking work. From the longer-run viewpoint, that kind of adjustment to restraint was the least painful one that could be hoped for. Many of the persons withdrawing were not primary income sources in their households. Also, political repercussions of increasing unemployment rates might be minimized. From the shorter-term view, however, the decline could easily be misread as indicating failure of the policy of restraint.

Mr. Bopp thought a much more damaging influence on expectations came from developments on the fiscal front. The fiscal outlook was, of course, chaotic at the moment, but the public must be convinced by now that Congress was in a mood to increase expenditures and cut revenues.

The Third District economy was exhibiting somewhat mixed signs, Mr. Bopp remarked. From July through October, manufacturing turned in four consecutive months of level or weakening activity.

The weight of scattered evidence now available for November suggested a fifth. Nevertheless, insured unemployment had remained low all year. In November, it was up but only seasonally.

Everyone tended to read the signs somewhat differently, Mr. Bopp observed, but as he saw them, a change in expectations had yet to be achieved. Bringing about such a change was of predominant importance right now because restraint was many months old, signs of success still were not clear, and the credibility gap was still there.

Mr. Bopp said he would vote for a policy of no change during the next four weeks. However, he recognized the problems that seasonal factors and taut liquidity positions might pose for the Desk, and the difficulty of predicting the impact of such factors on the aggregates. Given those problems, and the fact that growth in bank credit this quarter was estimated to be modest indeed, he would give the Desk considerable latitude in carrying out the policy directive.

Mr. Hickman said that additional economic evidence had reconfirmed previous forecasts of a slowdown in over-all activity. Continued accumulation of inventories in the fourth quarter, further deterioration in retail sales and consumer sentiment, and extended declines in industrial production suggested that the economy might be in the initial stage of a business contraction.

The sharp drop in the unemployment rate in November could be explained largely in terms of reduced labor force participation, which was a typical phenomenon in business slowdowns. Recent developments in insured unemployment and overtime hours provided additional evidence of softening in an over-tight labor market.

It appeared, Mr. Hickman continued, that fiscal policy would become progressively more expansionary over the next year or so and would be of little help in the fight against inflation. Under the circumstances, monetary restraint was still called for, but the System should avoid severe restraint as a means of compensating for the inappropriate shift to fiscal stimulation and budget deficits. Indeed, he continued to believe that monetary policy had been much too restrictive for many months. As a result, there was a distinct possibility that the Committee would eventually find itself in the worst of all possible worlds--with easy money, an unbalanced budget, price inflation, and rising unemployment.

Mr. Hickman was concerned by current record levels of interest rates in all segments of the credit markets, especially in the long-term markets, and by the recent further deterioration in market psychology. The near-disorderly conditions that had developed in the money market last week would probably not have occurred under a more moderate and sustainable monetary policy. If disorderly conditions persisted, the System might be forced to make an abrupt shift in monetary policy from an appropriate path of modest restraint.

The slight growth that had occurred in most reserve aggregates in the fourth quarter was desirable, Mr. Hickman remarked. Similarly, the adjusted credit proxy, after declining sharply in the preceding three months, had increased in the fourth quarter. Those developments, although inadvertent, had been appropriate and should now be adopted as a longer-term policy goal. He supported alternative B of the staff's draft directives, and would favor a policy of moderate expansion in bank reserves and bank credit for the foreseeable future. He would leave Regulation Q ceilings unchanged.

Mr. Sherrill said he was encouraged by the increasing pace at which the rate of real economic growth was slowing and by the continued moderate pattern of consumer spending in the fourth quarter. Those considerations, taken alone, might suggest that the time for a change in monetary policy had arrived.

Unfortunately, Mr. Sherrill continued, a number of other factors militated against a relaxation of restraint at this time. Of these, the uncertain outlook for fiscal policy was primary. It was apparent that if legislation now under consideration in Congress were enacted, fiscal restraint would give way to fiscal stimulus.

Other considerations included the decline in the unemployment rate in November and the strength of business capital spending plans reflected in the latest Commerce-SEC survey, Mr. Sherrill observed. Corporate executives apparently continued to feel the need to defend against rising labor costs by increasing their investments in plant and equipment. Such a course was quite logical from their point of view, so long as the longer-term outlook appeared to be inflationary. Evidently an inflationary psychology still prevailed.

Under the circumstances, Mr. Sherrill remarked, he would favor alternative A for the directive. However, he agreed with the view that the Manager should not resist any rate declines that resulted either from a change in market psychology or from a reduction in credit demands.

Mr. Brimmer said he agreed with the staff's analysis and with most of the views expressed so far in the go-around. In his judgment this final meeting of the year was definitely not the time to change the stance of monetary policy. Accordingly, he would support alternative A for the directive.

Mr. Brimmer expressed the hope that the Desk would not permit the expected disturbances in financial markets over the year end to force an unintended change in the impact of monetary policy. It was his impression from conversations with bankers and others that there were widespread expectations of a policy change around the year end, in light of the projections of large outflows from thrift institutions and other financial strains. And many people expected to be bailed out under what they thought were Government commitments to a low ceiling on unemployment and to a high floor under profits. While the Federal Reserve would be under a great deal of pressure to do something for the savings institutions, the housing industry, and so forth, he would hope that it would remain steadfast and not let itself be maneuvered into a position in which it had no alternative but to change policy.

In sum, Mr. Brimmer said, he agreed that the Manager needed leeway to deal with year-end pressures, but he hoped that that leeway would be used wisely.

Mr. Maisel thought it was clear that over the year end the Committee's principal concern would be with the viability of the credit markets. It need not, even if it should, act on the basis of prospective changes in spending since the more immediate questions lay in the money and credit markets.

As he interpreted the Manager's reports in recent weeks, Mr. Maisel continued, he thought the Manager had properly paid attention to the distressed state of those markets in his handling of operations. He would assume that until the next meeting the Manager would of necessity put major emphasis on those problems.

For purposes of operations during the next period, Mr. Maisel said, he would define "unusual liquidity pressures" as any increases above existing levels in rates on Treasury bills, medium-term agency issues, and long-term Governments. In other words, the proviso should be considered as giving the Manager sufficient latitude to accept lower Federal funds rates and lower net borrowed reserves if any of the major credit rates rose above their current yields. The Committee members all recognized that those rates were at record levels and reflected the existence of unusual liquidity problems. The need to offset float also created a difficult problem in the coming week. The Manager should not strain, now or later, to hold to artificial levels.

In the same way, Mr. Maisel continued, the Manager should not feel obligated to tighten if the credit proxy actually expanded in the 3 to 5 per cent range. In fact, such a range would be preferable to that which the staff had projected. A movement of that type would again presumably reflect the need of the entire financial system for liquidity for year-end and other purposes. If, on the other hand, the aggregates failed to move as expected, the situation would be of the type Mr. Partee had described and more immediate action would be required.

Mr. Maisel said that while he rarely suggested changes in the first paragraph of the draft directive, he would suggest a revision in the sentence in today's draft relating to the money supply. It seemed to him somewhat misleading to state that the money supply "increased relatively rapidly in November" when the increase was below usual rates and particularly when, according to the current figures, its level now was actually below that at the end of October. To give a more accurate picture, he would favor formulating the statement in terms of developments in October and November together.

It should be clear from his remarks, Mr. Maisel observed, that he hoped that in the process of meeting year-end turbulence an additional relaxation of money market conditions would come about. That would seem to be about what the market expected as a result of the problems to be faced between now and the end of the year as well as the necessary unwinding in the beginning of January. With those sorts of movements, at its next meeting the Committee should be ready to ratify the necessary conditions to allow the monetary aggregates to grow at a normal rate in relationship to the desired increases in the GNP. It seemed to him that the type of action he had suggested could be accomplished under either alternative A or B of the directive. Since he thought if the Committee changed it should move to a directive with more emphasis on aggregates, he had no desire at this time to substitute B for A.

Following Mr. Maisel's remarks there was a brief discussion of possible revisions of the statement on the money supply in the draft directive. It was agreed that the staff should continue to consider means for coping with the problem Mr. Maisel had mentioned, and the go-around resumed with comments by Mr. Mitchell.

Mr. Mitchell remarked that he also agreed with most of the views expressed today. The economy might already be in a state of recession, and he thought the problem was to keep the recession from becoming so severe that the System would be forced into a headlong retreat from restraint. The risk of such a development might not be great at the moment but it certainly would grow if the volume of new loan commitments by banks continued to fall at the rate reflected in the latest survey on the subject. On the other hand, it was necessary to continue the process of eroding inflationary expectations, although he believed that that process had proceeded further than others might think.

Under present conditions, Mr. Mitchell continued, he would not like to see the aggregates decline. Many observers attached more significance to the behavior of the aggregates than the Committee did, and they would erroneously interpret declines as conveying a policy signal. Certainly, it would be undesirable for the aggregates to move down just at a time when it became clear that a recession was under way.

Mr. Mitchell said he was prepared to vote for alternative A for the directive. However, he would prefer to replace the two-way bank credit proviso shown in the staff draft with a one-way proviso calling for operations to be modified "if bank credit appears to be contracting."

Mr. Heflin remarked that while some of the latest economic statistics were both confusing and disturbing, on balance the data indicated that there had been some cooling in the economy. From the vantage point of a Federal Reserve Bank it seemed clear that the commercial banks were getting the message of economic restraint.

However, Mr. Heflin continued, it appeared that businessmen were not yet getting the message. The tax and expenditure decisions now being made would determine the nature of business expectations in the period ahead and the role that monetary policy would have to play. For that reason, he thought the next meeting of the Committee would be the appropriate time to consider a policy change, and that it would be premature to make an overt move toward relaxation at present.

However, Mr. Heflin said, he also thought it was important to avoid any suggestion that monetary policy was being tightened further. He agreed that any doubts should be resolved on the side of ease. With that background, he would favor alternative A for the directive.

Mr. Clay remarked there was gradually accumulating evidence of progress in restraining economic activity as a forerunner to checking price inflation. The progress was quite moderate thus far, and price inflation continued very intense. The most notable exceptions were the lower unemployment figure and the enlarged business fixed capital spending plans.

Unemployment data for the last three months had to be interpreted along with other labor force changes, Mr. Clay continued. The best perspective could be gained by looking at employment growth--which had been slowing down for several months. At the same time, it had to be recognized that qualified labor remained very scarce. The business spending plans were disturbing as an indication of what business apparently intended to do. Perhaps those projections came into better perspective, however, when note was taken of the greater concentration in public utilities and communications and the smaller emphasis in manufacturing industries.

Mr. Clay commented that the most disconcerting development of recent days had been Congressional action on the fiscal front. Fiscal prospects had not been very encouraging even prior to recent Congressional actions. It was to be hoped that that latest threat to appropriate public economic policy could be averted.

Mr. Clay went on to say that restraint on economic activity had to be continued to slow further demand for goods and services, to reduce business profits, and to bring additional slack in the economy, so as to create the conditions that could lead to correction of price inflation. Better fiscal policy was crucial not only to assist in the fight against inflation but also to reduce the burden on monetary policy. The heavy concentration of wage negotiations in the year ahead constituted a difficult hurdle in the effort to reduce price inflationary pressures. It was going to take restraining pressure for a considerable time if price inflation was to be corrected. Two quarters of no real economic growth followed by an economic upturn was not likely to set the stage for price stability. In fact, the anticipation of such a growth pattern was an important factor in the current inflationary expectations.

Alternative A of the draft economic policy directives appeared to Mr. Clay to be the appropriate choice today. The proposed wording calling for maintenance of prevailing firm conditions in "the money market" rather than in "the money and short-term credit markets" was preferable in view of the special circumstances surrounding the Treasury bill market currently. Also, the proposed addition to the proviso clause of a reference to possible liquidity pressures appeared to be in order in view of the financial stringency that could develop in the weeks ahead.

Mr. Scanlon said that although signs of a slowdown in activity were now clearer in the Seventh District, opinions on the pattern for next year were showing greater divergence. Views varied from expectations of a continued inflationary prosperity through 1970 on the one hand to fears of a serious recession on the other. An important factor making for uncertainty was the marked contrast between decided weakness in demand for important classes of consumer durables and significant strength in demand for most types of producer equipment.

Mr. Scanlon observed that recent surveys of consumer attitudes indicated continued apprehension concerning the future, and reports from merchandisers remained bearish. But consumers clearly had the capability of increasing expenditures relative to income.

Mr. Scanlon noted that bank loans in the District had followed a zigzag course over the past month, with only a small net growth. Information for the past two weeks indicated a strong demand, which was probably seasonal for the most part. But since the first of November the weekly reporting banks showed almost no change in major loan categories, compared with large increases in the same period a year ago. The difference was considerably greater than the volume of loans sold. Banks continued to lean heavily on commercial paper, Euro-dollars, and Federal funds. In addition, weekly reporting banks in the District continued to liquidate investments, and their acquisitions of nondeposit funds were not large enough to permit any net increase in credit. There had been minimal resort to the discount window.

As to policy, Mr. Scanlon supported the position set forth by Mr. Partee He would like to see some modest growth in monetary aggregates, but because he believed there were some serious questions on the fiscal outlook he would hesitate to make an overt move toward ease at this time. He would encourage the Manager not to resist any downward tendency in rates and to resolve any doubts on the side of ease. He favored alternative A for the directive.

Mr. Galusha said he favored no change in Committee policy this morning. It was not so much that the most recent Commerce-SEC survey suggested a larger-than-hoped-for first-quarter increase in business fixed investment spending, for the survey was really rather encouraging. Large increases in plant and equipment spending would evidently be confined to a few industries, so continued inflation might not be as widely expected as earlier in the year. The Minneapolis Bank's directors' survey tended to support that view.

But it was easy to worry about the Federal budget, Mr. Galusha continued. He was not at all encouraged by what Congress had done so far, and would prefer to keep Committee policy unchanged at least until Congress and the President had finished with the new tax bill. Also, come January the Committee should know better just how weak consumption was. In short, he affirmed the logical and incisive reports of the staff.

Thus, Mr. Galusha remarked, he favored alternative A of the draft directives and the money market targets associated with that alternative in the blue book.[1/] He agreed that "the money market" should be substituted for "money and short-term credit markets," and that there should be reference to "unusual liquidity pressures" in the proviso clause. He shared the precautionary notes sounded by Messrs. Partee and Mitchell about the timing on which the proviso clause should be activated. He endorsed Mr. Hayes' observations about Regulation Q.

Mr. Merritt remarked that like most others who had spoken thus far he favored maintaining the recent policy stance.

1/ These included ranges of 8-1/2 to 9-1/2 per cent for the Federal funds rate, $1 billion to $1.5 billion for member bank borrowings, and $900 million to $1.2 billion for net borrowed reserves. The range for the three-month bill rate specified as consistent with these conditions was 7-1/2 to 8 per cent, but it was noted that the bill rate could move to or even below the bottom of the range specified during the latter part of the coming inter-meeting interval.

Mr. Merritt then noted that the San Francisco Reserve Bank had made an expanded survey of Twelfth District thrift institutions last week. Altogether, information on savings flows in the December grace period was obtained from 20 institutions--2 mutual savings banks and 18 savings and loan associations--in California, Washington, Arizona, and Nevada. The respondents accounted for 28 per cent of the total assets of such institutions in those four States. Those data, together with information from other sources for earlier periods, led to the following conclusions: First, in October of this year Twelfth District savings and loan associations experienced the largest outflow on record for that month. A very high volume of withdrawals more than offset a fairly high level of new savings. The net loss of $258 million was 70 per cent of the $366 million outflow experienced by all savings and loan associations nationally, and was substantially greater than the $159 million loss during October 1966. Over 90 per cent of the District's October 1969 loss occurred in California, although 6 of the 9 District States had net savings outflows. At the same time, loan commitments maintained their long decline, but the volume of mortgage loans outstanding continued to climb on the supporting strength of liquidation of cash and Governments and increased borrowings from the Federal Home Loan Banks. The level of such borrowings reached a new record high of $3,863 million at the end of October.

Secondly, Mr. Merritt continued, District institutions lost funds in November--in contrast to what appeared to have been a respectable savings gain nationally, and despite gains for District S&L's in each of the three preceding Novembers. But the November losses were at a much more modest rate than during the preceding month. Losses for California savings and loans might well have fallen within the range of $60-$90 million.

Finally, Mr. Merritt said, the net outflow of funds carried over into the December grace period and by the tenth of December it might easily have exceeded the loss for the whole previous month. Losses were experienced in three of the four States sampled; Arizona alone reported net gains, but the sample was thin. Some of the losses were continuing after the tenth of the month, much to the surprise of the reporters, and even heavier losses were expected after the end of the year. Christmas-club drawdowns and investment opportunities contributed to the outflows in all States. In addition, property taxes, which had increased this year in many communities, were due in December in California, and that reason was cited as an important factor explaining the outflow in that State. Revisions in the Federal Home Loan Bank Board regulations now permitted California and Nevada associations to pay 5.25 per cent for funds left intact for six months, rather than for three years as previously provided, but little optimism was expressed regarding the new measure.

Mr. Coldwell reported that economic activity in the Eleventh District had risen slightly from the September level. However, there was evidence that the rate of growth was decelerating, especially in the consumer purchasing, construction, and employment fields. An advance in the industrial production index for Texas paralleled the increase in crude oil output during October, and District employment rose more than seasonally with unemployment declining sharply. Even the decline in new construction contracts was halted in October, but the decline apparently resumed in November and early December. In fact, recent reports appeared to indicate that commitments for single-family housing starts had virtually stopped in several major cities of the State. On the retail side, the Reserve Bank's most recent information appeared to indicate an actual decline in personal consumption during early December from the year-earlier level.

District agricultural conditions followed the general seasonal pattern, Mr. Coldwell said. Weather conditions were now interfering with the cotton harvest and further reductions were being made in the estimates of cotton output to a level of 4,485,000 bales, or 14 per cent below last year's output. The Texas livestock industry continued to expand, and on November 1, with 1,415,000 head of cattle on feed, the level was 41 per cent above a year earlier. Cash receipts from farm marketings in District States were 8 per cent more in the January-through-September period this year than a year ago, with all of the gain occurring in the livestock market.

Mr. Coldwell observed that banking conditions in the District reflected by the weekly reporting banks showed mixed changes, with demand deposits and loans advancing while total investments and time deposits declined. The increase in loans, however, was sharply below the totals in the corresponding period a year earlier, while the investment decline was not much different from the picture in the year-earlier period. Borrowings from the Federal Reserve discount window advanced in recent weeks but net purchases of Federal funds showed some reduction.

In a recent conference with the presidents of some of the larger District banks, Mr. Coldwell continued, all participants seemed to indicate that their prospective efforts would be aimed at holding their loan accounts at current levels only if deposit totals advanced somewhat. However, they expected some further attrition in time deposits caused by disintermediation and, consequently, were trying to reduce loan accounts. Those banks already were seeing a number of major U.S. corporations being forced out of New York and Chicago to the interior banks to draw upon unused commitment lines.

With respect to national conditions, Mr. Coldwell said he was persuaded that an economic slowdown was possible over the coming months and that with continued severe restraint there might yet be a classic adjustment to lower levels of consumption and production. If that should develop, given sufficient time, even the continued skeptics in the business world might see the wisdom of a slower pattern of capital expenditure. But he could envision that happy chain of events only if the Committee maintained its steady restraining pressure. To him, the fundamental cornerstone to that entire pattern of events rested on a slow or even slower consumer demand, and any action which caused a resurgence in consumption expenditures threatened both the whole process of retrenchment and the success of the efforts toward economic stabilization. In his opinion, the current position was characterized by a delicate balance, with business attitudes still reflecting optimistic and inflationary prospects while consumer attitudes were now showing some greater degree of pessimism. How long the dichotomy of expectations could continue was a central question in the process of disinflation.

Reinforcing the consumers' pessimism and dampening the inflationary expectations of business was the Committee's job over the next few months, Mr. Coldwell said. The hangover of repressed demand from unsatisfied borrowers constituted a continuing threat to the success of the Committee's endeavors. If that demand were to be satisfied so that such borrowings could obtain an effective status in the market, he believed they would regenerate inflationary pressures.

In light of those considerations, and in light of what appeared to be a developing stimulative fiscal posture, Mr. Coldwell was not prepared to reduce the pressure of monetary restraint. In fact, he was somewhat unhappy that the circumstances of the past two months had forced the Desk into such massive open market purchases--at rates nearly double the amounts of a year earlier. He recognized that the massive shifts of funds into and out of Treasury bills by the Germans and the Treasury bill flotations had caused a congestion in that market and the tone of the market had become depressed. But he wished the problem could have been met with more temporary measures than outright purchases, for he suspected that there were going to be conditions in the near future which might militate against a reversal of those purchases.

In consequence, Mr. Coldwell's prescription for monetary policy in the coming period, while permitting great leeway to the Desk to meet unusual strains, would be to mop up the seasonal reflows of funds, possibly even by the sale of coupon issues as well as of Treasury bills. In his opinion, the Committee had to continue to accept the risks entailed in a severely restrictive monetary policy. His contacts with businessmen at the head of some very large corporations indicated a continued disbelief in the ability of Government to reduce the inflationary fervor of the economy and an expectation of greater Government spending and continually rising costs, especially with new wage-settlement increases being validated by further price advances. With such underlying assumptions, it was to be expected that businessmen would continue to press for labor-saving technological capital expenditures.

Mr. Coldwell said he would accept alternative A for the directive, but would not interpret it in the manner Mr. Mitchell had suggested. He did not think the position he was taking was markedly different from that of others, and he would not publicize his position because he thought the members' disagreements should be handled within the Committee.

Mr. Morris observed that the evidence suggested to him that economic activity was now at or very close to a peak. There was even a fair possibility that the peak had already been passed. Peaks in economic activity were usually characterized by two conditions: First, by major crosscurrents in the incoming statistics; and second, by wide differences in economic forecasts--a fact which demonstrated that economists and businessmen were always more nearly unanimous in identifying trends than they were in identifying turning points. Those two conditions prevailed today.

Downward turning points were always difficult to identify until the economy was well into a decline, Mr. Morris remarked. One factor which strengthened his conviction that the economy was at a turning point was the development of what appeared to be a potentially major imbalance between investment and consumption. The incoming data on consumer expenditures, particularly on durable goods, suggested a pervasive weakness which tended to support the findings of the University of Michigan's Survey of Consumer Attitudes. At the same time, business investment proceeded at a rapid rate. Those incompatible trends carried with them the potential for a major adjustment ahead if they were to continue for long.

At the moment, Mr. Morris' reading of the data suggested that the adjustment in 1970 would be moderate in amplitude. He would associate himself with the general configuration of the staff projection for 1970--provided that there was a modification of the current monetary policy soon. The current severely restrictive policy might have been appropriate for a booming economy which was still accelerating, but in his judgment it was not an appropriate policy for an economy which was in the process of turning around. If his assessment of the economy was correct, it would be a mistake to aim for the contraction of bank reserves in January that directive alternative A would tend to produce.

Mr. Morris went on to say that during the past seven weeks, when the seasonal pressures in the money market had been growing more intense, the Manager--in following the money market guidelines laid down by the Committee--had permitted a significant growth in bank reserves which in Mr. Morris' judgment had been constructive. After Christmas, however, the seasonal pressures were likely to diminish and the application of the very same money market guidelines would probably produce an excessive contraction in bank reserves.

Mr. Morris believed that the stage in the cycle had been reached at which the Committee should no longer fear the impact of its actions on businessmen's expectations. The incoming business statistics were likely to take care of expectations. The events of the past year should teach the Committee that the businessman's order books had a lot more influence on his expectations than anything that the Committee could say or do--and he was confident that the trend in order books was downward.

Because he thought it was now unnecessary to be overly concerned about expectations, Mr. Morris believed the time had come to do something about Regulation Q. Specifically, he would suggest to the Board that it remove the ceiling on large-denomination CD's. Furthermore, he would suggest that the ceilings on commercial bank savings accounts and on small-denomination CD's be raised by 1/2 of 1 percentage point and that a corresponding increase be granted by the Federal Deposit Insurance Corporation and the Home Loan Bank Board to mutual savings banks and savings and loan associations.

As the Committee knew, Mr. Morris said, a test case in rate regulation had been under way recently in Massachusetts; there had been no effective ceiling rates on mutual savings banks in that State since July. The evidence to date suggested the following: First, the mutual savings banks had improved their earnings sufficiently since 1966 to be able to raise their deposit rates by 1/2 of 1 percentage point. He could think of no valid reason why that greater earnings capability should not be reflected in higher rates for deposits. Secondly, the mutuals were likely to use that new freedom prudently. Most of the mutuals in Massachusetts were still paying only 5 per cent on regular accounts. On the other hand, almost all were paying 5-1/2 per cent on special notice accounts. Third, the slightly higher rate level had made a difference, even though rates on market instruments were still very much higher than the rates they were paying. As evidence, since April--when Massachusetts mutual savings banks had received the new rate freedom--their deposits had risen at an annual rate of 6.6 per cent as against a gain of only 1.5 per cent for mutual savings banks outside Massachusetts. Savings banks could, of course, be taken care of through the discount window, and it was well that the System was prepared to do so, but it would be much sounder to permit them to utilize their higher levels of income to take care of themselves.

To sum up, Mr. Morris said, while he believed the Committee should follow a restrictive monetary policy for some months to come, he did not believe it should continue to follow the severely restrictive course it had been on since May. To do so would be to fail to recognize that it had already accomplished much of its objective. He thought it wise, of course, to prepare to meet a liquidity crisis, as the proviso clause in the draft directive suggested. However, he would think it much wiser to take the sort of action needed now to make it unlikely that the Committee would, by its actions, generate a liquidity crisis.

It was for those reasons that Mr. Morris would support alternative B for the directive--with one amendment. He thought the stage had been reached at which a one-way proviso clause was in order, to be operative for the next four weeks only if bank credit should deviate significantly below current projections. He would not delay that modest change in policy on the basis of a fear that the Congress would take irresponsible fiscal actions. Since no one could accurately forecast what the Congress would do, he thought the Committee should act on the facts now at hand and stand ready to shift policy again if the incoming data suggested the need for such a shift.

Mr. Robertson said he would confine his oral remarks to the observation that for the directive he favored alternative A amended along the lines suggested by Mr. Maisel, and he would submit the statement he had prepared for inclusion in the record. His prepared statement read as follows:

> It is obvious that we are moving through a crucial testing period for monetary decision-makers. The signals coming from the real economy, while not all unambiguous, appear on balance to indicate some further slowing--and actual sizable cutbacks in output in the industrial sector. But this slackening pace of real economic activity has not yet been sharp enough or sustained enough to compel any significant curtailment of the inflationary pace of price and wage increases. It would be unwise to base monetary policy action at this juncture on a forecast of a future calming of wage and price pressures; inflationary anticipations seem too deeply ingrained, and too much related to longer-run expectations, for us to be sure of how they will react. Furthermore, recent actions on the fiscal front have been so irresolute as to

raise serious questions as to the ultimate degree of fiscal restraint that will prevail in calendar 1970. Hopefully, responsible stands by the Conference Committee and the President in the next few days and weeks will erase these questions and preserve an anti-inflationary budgetary posture, but no one can be sure of that at this point in time.

Monetary decisions must also take into account the fact that we are today in the midst of peak seasonal pressures on financial markets and institutions. Financial aggregate flows have been seesawing, and most interest rates outside the narrow money market have touched new highs. Just ahead of us lies the touchy year-end interest crediting period for all deposit-type savings institutions, and there is a chance that the net withdrawals could be so bad as to call for some kind of emergency ameliorative action in order to soften an unduly adverse impact on the sectors dependent on these institutions for funds.

Weighing all these considerations together, I come to the conclusion that the Federal Reserve still cannot afford to take any overt easing action right now. But we also cannot afford to allow any disruptive movements of a tightening character to take place. This means we need to give the Manager ample flexibility to help counter any developments of the latter type that may break out in the weeks ahead. I personally would be happy--as I said last time--if the combination of market demands and System reserve responses worked out to produce a continued moderate rate of growth in the money supply, but I do not believe we can yet risk a significant easing move on our part to try to ensure such growth if the public's demand for money is not itself strong enough to elicit it.

There is reason to hope that the weeks ahead will bring some relaxation of seasonal pressures and some consequent down-drift in short-term rates, particularly the bill rate. I would want the Manager to accommodate any such rate declines rather than resist them. But I would not want his accommodative posture to extend to the kind of bill market manipulation he raised as a possibility in his report at

> the last meeting, namely, buying long bills with offsetting sales of shorter-term issues. That kind of maneuver, however attractive it may look in the short run, seems to me to reopen a Pandora's box of market manipulation issues over the longer run that would be more trouble than any possible immediate benefits are worth.
>
> On balance, therefore, I come out in favor of directive alternative A, with plenty of flexibility for the Manager to shade his targets of reserve availability and money market rates as necessary to counter any untoward financial developments.

Chairman Martin remarked that skepticism about the effectiveness of monetary restraint had almost disappeared. However, growing skepticism about fiscal policy was offsetting much of what had been achieved in the area of expectations. He thought the Committee had no real choice today except to maintain its present policy. Accordingly he favored alternative A for the directive. He preferred the two-way bank credit proviso shown in the staff's draft to the one-way clause suggested by Mr. Mitchell, and he had the impression that that was the sentiment of the majority also.

Mr. Mitchell said he did not feel strongly enough about the matter to dissent from a directive with a two-way proviso clause.

In response to a question from the Chairman, Mr. Holland said the staff, in consultation with Mr. Maisel, had worked out possible substitute language for the statement in the first paragraph of the draft directive that the Committee had discussed earlier. The proposed language read as follows: "Bank credit rose rapidly in November after declining on average in October, while the money supply increased moderately over the two-month period;".

It was agreed that the proposed language was preferable to that included at the corresponding point of the original staff draft.

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

The information reviewed at this meeting indicates that real economic activity has expanded only moderately in recent quarters and that a further slowing of growth appears to be in process. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have advanced further in recent weeks partly as a result of expectational factors, including concern about the outlook for fiscal policy. Bank credit rose rapidly in November after declining on average in October, while the money supply increased moderately over the two-month period; in the third quarter, bank credit had declined on balance and the money supply was about unchanged. The net contraction of outstanding large-denomination CD's has slowed markedly since late summer, apparently reflecting mainly an increase in foreign official time deposits. However, flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there is considerable market concern about the potential size of net outflows expected around the year end. In November the balance of payments deficit on the liquidity basis diminished further and the official settlements balance reverted to surplus, mainly as a result of return flows out of the German mark and renewed borrowing by U.S. banks from their foreign branches. 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 the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.

Chairman Martin then observed that the Committee had planned to continue today its discussion of the release of the Committee's minutes for the years 1962 through 1965. He asked Mr. Broida to comment.

Mr. Broida noted that the Secretariat had distributed two memoranda on the subject since the November 25 meeting. The first, dated December 5, was entitled "Possible means for handling sensitive passages in releasing FOMC minutes for years after 1961."[1/] The memorandum concluded with a recommendation that the Committee follow what was called "procedure 2(c)" in dealing with any passages it decided should be withheld when the minutes were initially transmitted to the National Archives. That procedure involved blanking out the sensitive

1/ A copy of this memorandum has been placed in the Committee's files.

passage but not retyping the page to "close up" the space; and introducing a footnote in each case that employed standard language to explain the deletion and also included an explanation of the general nature of the deleted material.

The second memorandum, Mr. Broida continued, was dated December 10 and entitled "Passages recommended for deletion when 1962 and 1963 minutes are initially released."[1/] There were five such passages, all in the discussions of foreign currency operations, which represented the residual of a longer list that had originally been identified as potentially sensitive. In each of the five cases the "other party" concerned with the passage had asked that it not be released at this time. In addition, since the memorandum was prepared the Bank of England had had second thoughts about one passage in the 1962 minutes it had cleared earlier, and it now proposed that that passage--indentified on pages that had been distributed to the Committee today--be withheld also.

As the Committee would note, Mr. Broida said, for each of the six passages now recommended for deletion, drafts had been provided of the explanatory footnotes that might be used if the Committee decided to follow procedure 2(c). The staff thought it would be appropriate to discuss the form of those footnotes with the other parties

1/ A copy of this memorandum has been placed in the Committee's files.

involved and requested authorization to modify their language if that appeared desirable after such discussions.

Mr. Broida remarked that the staff's review of the 1964 and 1965 minutes was proceeding faster than had been expected, and it seemed safe to say that the staff would have made recommendations to the Committee by the time of the next meeting. The present status of the work could be summarized briefly: The Board's staff had completed its review of the domestically-oriented parts of the 1964-65 minutes and had found no passages which it would recommend for deletion. The New York Bank staff's parallel review of the domestic material was well along, but not yet done. Initial reviews of the foreign currency discussions had been completed at both the Board and New York Bank, and a number of potentially sensitive passages had been identified. The process of clearing those passages with the other parties had already begun.

In response to the Chairman's inquiry, Mr. Coombs said he had no comments to add.

Mr. Solomon said he might mention that in the staff reports on balance of payments developments included in the minutes there were a few rather sharply worded statements about specific foreign countries which were not being recommended for deletion. In his judgment the Committee was not committed by anything a staff member might have said and the statements in question need not be considered a source of embarrassment to the Committee.

Chairman Martin expressed the hope that the work remaining before the 1962-65 minutes could be released would be completed as expeditiously as possible. He personally would have been happier if the minutes could have been made public without any deletions at all. Since other parties had objected to the release of specific passages, however, the Committee had no alternative but to withhold those passages at this time. He concurred in the staff's recommendation that "procedure 2(c)" be followed for the deleted passages.

Mr. Bopp observed that the quality and completeness of the proposed explanatory footnotes varied greatly. For example, in the first of the cases cited in the December 10 memorandum, both the deleted text and the explanatory material in the footnote were five lines in length. In the fourth case, however, sixteen lines were deleted from the text but the explanation in the footnote was limited to two lines. Presumably the brevity of the latter footnote reflected actual or anticipated objections of the other party to a longer explanation.

Mr. Bopp added that he would favor issuing a general statement when the minutes were released to the effect that passages had been withheld only when other parties had objected to their release and that the substance of the deleted material had been described in language satisfactory to the other party. It should be made clear that the deletions were made in the interests of maintaining good relations and not impeding future negotiations.

Chairman Martin agreed that an explanation along those lines would be useful.

Mr. Hayes commented that in some cases the other party involved might object to the inclusion of any material in the footnote that revealed the substance or subject matter of the deleted material. That possibility raised the question of whether the Committee should employ footnotes at all, or whether it should rely instead on a general explanation in the preface to the effect that certain passages had been deleted for specified reasons.

Mr. Holland observed that each of the draft footnotes started with a standard sentence indicating that material had been deleted "for one of the reasons cited in the preface." It was the staff's thought that the footnote could be confined to that standard sentence if the other party objected to the inclusion of any further statement regarding the substance of the deleted material.

Mr. Brimmer noted that the staff's December 5 memorandum included background information on the State Department's procedures for dealing with sensitive material in publishing diplomatic records. He was pleased to see that the staff had developed more detailed information on that subject than had been available at the time of the last meeting.

Mr. Brimmer then remarked that the procedure the staff had recommended seemed to him to represent an appropriate compromise between the wishes of the other affected parties and the needs of historians. He was somewhat troubled by Mr. Hayes' comment, because deleting the footnotes entirely would deprive historians of useful information. He would be prepared to have the staff engage in extended negotiations with the other parties in an effort to formulate explanatory footnotes that included as much as possible of the substance of the deleted text.

Chairman Martin said there was a good deal of merit to Mr. Brimmer's observation. He then asked whether there would be any objection to adopting procedure 2(c) and authorizing the staff to modify the language of the explanatory footnotes if that seemed desirable after discussions with other parties. No objections were raised.

Mr. Brimmer said it would be highly desirable to release the minutes through 1965 before the end of January 1970. He asked whether the staff thought that would be feasible.

Mr. Broida replied that it should be possible to announce in that period that the minutes had been transmitted to the National Archives. However, some time would be required for Archives to microfilm them for the use of interested persons.

Mr. Hayes then said he would like to advise the Committee of an action the Conference of Presidents had taken yesterday relating to the rates on advances to individuals, partnerships, and corporations other than member banks under the last paragraph of Section 13 of the Federal Reserve Act. As the Committee members knew, that rate was now 7 per cent at some Reserve Banks and 7-1/2 per cent at others, in contrast to the uniform 6 per cent basic discount rate. At its September meeting the Conference had expressed the view that it would be desirable to have uniformity of rates on such advances, and had asked the Subcommittee on Discounts and Credits to make specific recommendations as to the method for achieving uniformity and the timing of such action.

Yesterday, Mr. Hayes continued, the Conference had approved three recommendations of the subcommittee, and had agreed that the Federal Open Market Committee should be informed of the action since the matter was of interest from a credit policy standpoint. The subcommittee's recommendations were first, that the rate on advances to nonmember institutions should be realistic, and yet a penalty rate; second, that the differential between the nonmember rate and the basic discount rate should be subject to variation as circumstances dictated; and third, that a move toward uniformity of the nonmember rate should be undertaken preferably in conjunction with future changes of other Federal Reserve lending rates.

Mr. Hayes noted that the subcommittee had considered the appropriate differential with respect to the present 6 per cent basic discount rate, which was out of line with the market. The Conference had agreed with its conclusion that a differential of 3 percentage points above the 6 per cent rate would now be appropriate. Other differentials might be appropriate under different circumstances; for example, the 2 percentage point differential suggested by the Secretariat for the Fundamental Reappraisal of the Discount Mechanism might be proper when the basic discount rate was more nearly in line with market rates. Since the matter could not be predetermined, the Conference had agreed that it should discuss the differential at such time as a change in the basic discount rate seemed to be in the making. No change in the nonmember rate to achieve uniformity seemed desirable now because of the extremely limited use of this form of Federal Reserve credit and because a change at this time could arouse expectations of an increase in the basic discount rate. It was possible, of course, that use of the type of credit in question could expand suddenly as a result of an emergency situation. In that event, consideration could be given at that time to a change in the nonmember rate.

Mr. Hayes added that the Conference had also considered the proposed contingency plan for generalized emergency borrowing, on which the Board had requested comments by letter dated September 24, 1969. One of the conclusions reached was that the rate on loans by member banks to nonmember banks in "conduit" arrangements should be the same as the rates by the Reserve Banks to nonmember institutions under the last paragraph of Section 13.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, January 13, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

Attachment A

CONFIDENTIAL (FR) December 15, 1969

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on December 16, 1969

FIRST PARAGRAPH

The information reviewed at this meeting indicates that real economic activity has expanded only moderately in recent quarters and that a further slowing of growth appears to be in process. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have advanced further in recent weeks partly as a result of expectational factors, including concern about the outlook for fiscal policy. In October bank credit declined on average and the money supply changed little, but both increased relatively rapidly in November; in the third quarter, bank credit had declined on balance and the money supply was about unchanged. The net contraction of outstanding large-denomination CD's has slowed markedly since late summer, apparently reflecting mainly an increase in foreign official time deposits. However, flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there is considerable market concern about the potential size of net outflows expected around the year end. In November the balance of payments deficit on the liquidity basis diminished further and the official settlements balance reverted to surplus, mainly as a result of return flows out of the German mark and renewed borrowing by U.S. banks from their foreign branches. 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 the money markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.

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 slightly less firm conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections or if unusual liquidity pressures should develop.