

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 Thursday, January 15, 1970, at 9:30 a.m.^{1/}

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

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Kenyon and Molony, Assistant
Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Baughman, Gramley, Green,
Hersey, and Tow, Associate Economists

^{1/} This meeting, originally planned for January 13, 1970, had been postponed two days because adverse weather conditions prevented several members of the Committee and staff from reaching Washington by the former date.

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Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Bernard, Assistant Secretary, Office of the Secretary
Mr. Cardon, Assistant to the Board of Governors
Messrs. Coyne and Nichols, Special Assistants to the Board of Governors
Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Eisenmenger, Parthemos, Jones, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Richmond, St. Louis, and San Francisco, respectively
Mr. Hocter, Vice President, Federal Reserve Bank of Cleveland
Messrs. Garvy and Kareken, Economic Advisers of the Federal Reserve Banks of New York and Minneapolis, respectively
Messrs. Meek and Honea, Assistant Vice Presidents of the Federal Reserve Banks of New York and Atlanta, respectively
Mr. Willes, Senior Economist, Federal Reserve Bank of Philadelphia

Chairman Martin noted that his term of office expired at the end of the month, so that--barring an emergency--this would be the last meeting of the Committee that he would chair. It had been a great privilege for him to serve in the capacities of Chairman of the Board and of the Committee for nearly nineteen years and he was deeply

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appreciative of the help he had received from the members of those bodies and from Federal Reserve people generally over the whole period of his association with the System.

The Chairman then said that he might take this occasion to mention again the need for preserving the confidentiality of the Committee's discussions. That need was particularly great at the present critical juncture for economic policy-making.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on December 16, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on December 16, 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 December 16, 1969, through January 7, 1970, and a supplementary report covering the period January 8 through 14, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that, after monetizing \$1 billion of gold last week, the Stabilization Fund still had more than \$500 million of gold on hand with no major sales or purchases in sight at the moment.

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For the past week the free market gold price had fluctuated just below the \$35 figure, reaching a new low of \$34.80 today. There were indications of persistent selling from some sources other than South Africa--possibly one or more of the Soviet bloc countries. Meanwhile, as the price held at or below \$35, South Africa was each day acquiring rights to sell gold to the International Monetary Fund at a rate equivalent to current gold output, or roughly \$5 million per day.

On the exchange markets, Mr. Coombs continued, the German mark was subjected to heavy pressure during the second half of December and net reserve losses since abandonment of the previous parity had now risen to \$5.3 billion. Much of the pressure during December apparently derived from repatriations of mark balances by U.S. corporations to meet their targets under the Commerce Department's program. There also seemed to have been sizable drawings by the same corporations on lines of credit previously granted to them by German banks. Since the turn of the year the pressure on the mark had abated with only minimal reserve losses during the past two weeks. Some rebuilding of mark balances by U.S. corporations might now be developing while the general tightening of credit conditions in Germany had lifted money market rates close to those prevailing in the Euro-dollar market. The German authorities now seemed determined to resist strongly any sizable further outflows

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and they had a good many policy instruments at their disposal to protect their reserve position. For example, he would not be surprised to see some move in the direction of voluntary restraint measures, particularly directed at foreign borrowing in Germany.

Meanwhile, Mr. Coombs remarked, the German Federal Bank had been able to mobilize a very large amount of funds, including \$1.1 billion of earlier credits to the IMF plus the proceeds of a conversion, ahead of maturity, of nearly \$740 million of mark bonds issued by the U.S. Treasury. The Federal Bank also had received heavy repayments of short-term credits previously extended to the Bank of England and the Bank of France. If the Germans now succeeded in stabilizing their reserve position, that would have major implications for other countries during the coming months. During the fourth quarter of 1969 Germany had been releasing funds to the international financial markets at an annual rate of more than \$20 billion, with corresponding benefit to its trading partners. Conversely, if the outflows from Germany now ceased there would be a much clearer picture of the underlying situation of a number of Germany's trading partners.

Mr. Coombs commented that the Italian lira, if now deprived of further return flows from Germany, might well come under serious pressure and the French franc might also show less strength than in recent months. There had been,

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however, a considerable improvement of the underlying trade position of France and he would doubt that the emergence of any new selling pressure on the franc over the next month or two would develop into a crisis situation. As the Committee knew, the Bank of France had made a new drawing on the System last week. Recourse to the line was helping the Bank of France to pay off at maturity earlier credits received from the German Federal Bank and they represented a form of interim financing. At the Basle meeting last weekend, the Deputy Governor of the Bank of France had indicated to him that they expected to pay off the drawing on the swap line completely by making a further drawing on the IMF early in February. In general it seemed to him that the Bank of France was handling its financing problems in a skillful and business-like way.

The most puzzling development during the past two weeks, Mr. Coombs observed, was the virtual absence of any dollar gains by the Bank of England. The British monetary authorities had been counting on January's being a good month, as it had been in previous years, but the experience since the turn of the year had been disappointing. Perhaps the pull of high Euro-dollar rates was inducing covered capital outflows; forward sterling had been unusually strong. The drying up of outflows from Germany might also be a factor, together with a delayed return to London of funds repatriated by U.S. corporations before

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year end. Some uneasiness in the exchange markets might also have been created by reports of new strong pressures for wage increases and by the risk that the British Government might take a series of easing actions to help set the stage for an election in the late spring. Yesterday, however, the Bank of England took in \$30 million and that might mark the beginning of the usual seasonal strengthening of sterling.

By unanimous vote, the System open market transactions in foreign currencies during the period December 16, 1969, through January 14, 1970, were approved, ratified, and confirmed.

Mr. Coombs said he would like to bring a matter to the Committee's attention to determine whether the members concurred in his understanding of it. It would be recalled that in June 1969 the Committee had temporarily authorized a liberalized interpretation of the authority for warehousing operations for the Treasury's Stabilization Fund. Under the previous interpretation, \$350 million of the \$1 billion authority established in the authorization for System foreign currency operations had been considered to be available for the general purposes of the Stabilization Fund, and the remaining \$650 million was restricted to financing the Second Sterling Balances Arrangement. The Committee had agreed last June that the System could temporarily enter into warehousing arrangements with the Treasury up to the

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full \$1 billion without restriction as to currency or purposes, on the understanding that that liberalized interpretation would lapse once the Treasury made a decision on gold monetization and reversed the warehousing transactions. As the members knew, last Thursday (January 8) the Treasury had monetized \$1 billion in gold and repaid \$950 million in warehousing arrangements with the System, leaving \$50 million outstanding. It was his understanding that the original interpretation of the warehousing authority was once again in effect; that is, \$350 million was available for the general purposes of the Stabilization Fund and \$650 million was reserved exclusively to finance the Treasury's participation in the Second Sterling Balances Arrangement. The Treasury was agreeable to such an arrangement.

Chairman Martin asked whether there was any disagreement with the Special Manager's understanding of the matter under discussion, and none was expressed.

Mr. Coombs noted that a Federal Reserve drawing on the Netherlands Bank, in the amount of \$130 million, would reach the end of its first three-month term on January 29, 1970. He was hopeful that it would prove possible to pay that debt down somewhat over the next few weeks. He would recommend renewal for another three-month period of any balance that remained outstanding at maturity.

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Renewal of the System drawing on the Netherlands Bank maturing January 29, 1970, was noted without objection.

Mr. Coombs then observed that three drawings by the Bank of England would reach maturity during the middle of February. On February 11 a drawing of \$215 million would have been outstanding for nine months; and on February 13 and 17, respectively, drawings of \$100 million and of \$60 million would reach the end of six-month terms. More importantly, the swap line had been in continuous use since July 1, 1968--which would be nearly 20 months by mid-February. Normally, he would have requested Committee approval of further renewals of the three swap drawings at this meeting. He was reasonably confident, however, that the \$215 million drawing falling due on February 11 would have been paid off by then. There would still be time at the next scheduled meeting of the Committee on February 10 to discuss the possible renewal of the two drawings maturing on February 13 and 17 if it appeared that the British were likely to request their renewal.

Mr. Coombs then said he would like to report to the Committee on discussions Mr. Hayes and he had had with both Bank of England officials and Chancellor Jenkins on the matter of British debt repayments, and to seek the Committee's advice

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on tentative repayment proposals which had turned up in those discussions. The debt repayment problem faced by the British during the remainder of the first quarter of 1970 involved three main elements: \$525 million due to the Federal Reserve; \$550 million of overnight credits received from the U.S. Treasury; and \$890 million due to the U.S. Treasury and various foreign central banks under the November 1967 package. The total debt of about \$2 billion clearly would far exceed British repayment possibilities during the first quarter of 1970, even if full advantage were taken of the addition to Britain's reserves arising from the allotment of \$410 million of SDR's. It seemed clear, therefore, that if any creditor was to be paid off in full some repayment priorities would have to be set.

Mr. Coombs said he was glad to report that the British would now be prepared to accept the following repayment schedule. First, the Federal Reserve would get a very high priority on all debt repayments available from current dollar receipts by the Bank of England. Secondly, the Federal Reserve would also get a special debt repayment, possibly as much as \$200 million, at the end of January as a partial offset to the \$410 million of SDR's that would be taken into the British reserves at month end. Third, the overnight credits from the

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U.S. Treasury would be reduced at the end of January from \$550 million to a range of \$250 - \$350 million, as the remainder of the reserves Britain had gained through SDR allocation was allotted to that purpose. Fourth, if repayments in January and early February from current dollar receipts and SDR's were not sufficient to clear up the outstanding \$525 million Bank of England debt to the Federal Reserve by February 15, the Bank of England would be prepared to negotiate a short-term credit-- up to \$200 - \$250 million--from the Bank for International Settlements to finance repayment of the balance. The BIS had already indicated to the Bank of England that it would be agreeable to extending such a credit on a three- or six-month basis.

The fifth point, Mr. Coombs said, was that the Bank of England would avoid new drawings on the Federal Reserve swap line from February 15 until March 31, and would devote new dollar receipts in that period to paying off the U.S. Treasury overnight credits and borrowings from the BIS, as well as debt to the continental central banks. Sixth, as of March 31 the Bank of England would feel free to draw again on the Federal Reserve swap line to compensate for any reserve loss then

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occasioned by renouncing further overnight credits from the U.S. Treasury. Such drawings, in effect, would not be to finance market losses but to replenish cash balances and would be similar to pilot operations in 1962. Finally, the Bank of England would also feel free during the period from April through July 1970 to draw further on the Federal Reserve swap line to help repay any residual debt owing to the BIS.

The essence of that repayment proposal, Mr. Coombs said, was the time sequence under which the Federal Reserve would be repaid first--by February 15, if not earlier; and the fact that the System would then provide a backstop if British dollar receipts in subsequent months did not fully cover debt due to the Treasury and the BIS. In his judgment, the proposal offered a more practical and effective means of getting the British swap line cleared than any of the alternatives that had been considered.

Mr. Daane asked whether the Bank of England's negotiations with the BIS were contingent on the backstop arrangement with the Federal Reserve.

Mr. Coombs said he did not think there was a direct link between the Federal Reserve swap line and any BIS credits

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to the Bank of England. Of course, the BIS would be interested in reasonable assurance that the British would be able to repay any borrowings from it. The fact that the British could draw \$2 billion on the swap line, if it were fully cleared, would be relevant in that connection, just as would be the possibility of British drawings on the IMF.

Mr. Daane noted that the proposal involved shifting borrowings from one creditor to another and asked why the British would find such a procedure advantageous.

Mr. Coombs replied that the Bank of England was anxious to pay off completely its drawings on the Federal Reserve swap line at this time for the same reasons that it had desired to clear up the line on the two earlier occasions when drawings were running on for a relatively long period. First, it wanted to preserve the principle that the swap line represented a short-term credit facility. Secondly, it expected a favorable market reaction to the announcement that it had fully repaid its debt to the Federal Reserve. There was a parallel in recent System relations with the Bank of France. As the Committee would recall, in late spring of 1969, when Bank of France drawings on its swap line with the Federal Reserve were approaching the one-year limit, the French drew on other central banks to clear up the System line.

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Now, eight months later, they were making small drawings on the System to clean up credits from the German Federal Bank and were planning to make an IMF drawing to repay the Federal Reserve. In general, if a central bank followed the practice of making proportionate repayments on all of its outstanding debts there was a chance that it would remain in debt to all of them for very long periods. Sequential payments avoided that risk.

Mr. Daane asked whether the concept of a swap line as providing a "backstop" represented a departure from the customary understanding of the purpose of such lines.

Mr. Coombs replied that he would consider the principle of a backstop to be related to that of a credit package, in which a group of credits was extended but the recipient did not necessarily draw on all of them on a pro rata basis. The main advantage to the British of clearing up the swap line with the System was that the facility was renewable.

Mr. Hickman said that the general approach Mr. Coombs had outlined seemed to be a good one. However, he would hope the British would not get into the habit of viewing the swap line as, in effect, an addition to their reserves. In other words, he hoped they would not come to regard it as always available to finance repayments of debts to others.

Mr. Coombs agreed that that was a risk to be guarded against, and he felt sure that the Bank of England people would take the same view of the matter.

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Mr. Mitchell referred to the \$890 million which Mr. Coombs had indicated the British owed to the U.S. Treasury and certain foreign central banks, and asked whether any of that debt had to be repaid in the current quarter.

Mr. Coombs replied in the negative. He noted that those credits represented the balance of a special package, arranged after the British devaluation in November 1967, in which the Federal Reserve had not participated. The credits had been outstanding considerably longer than the British had been making continuous active use of the Federal Reserve swap line, which was since July 1, 1968. Fortunately, the various creditors under that package were agreeable to having priority given to repayment of the debt to the System.

In reply to a question by Mr. Mitchell, Mr. Coombs said that if the British were unable to repay the U.S. Treasury's overnight credits by March 31 by the means he had described it was possible that the Treasury would be willing to convert the balance to the ordinary type of cash credit.

Mr. Mitchell asked how likely it was that the British would have to draw on the credit facilities to be offered by the BIS.

Mr. Coombs replied that it was difficult to say. Britain's payments balance ordinarily was seasonally strong in the first quarter and it was conceivable that their dollar inflow

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would be large enough--when combined with the SDR allocation-- to make recourse to the BIS credit unnecessary. On the other hand, the absence of any significant inflow in the first two weeks of the year was disappointing.

Chairman Martin commented that recent wage demands in Britain might well have dampened enthusiasm for holding additional sterling. He added that in his judgment Mr. Coombs had worked out an excellent program for dealing with a difficult situation.

The Chairman then said he might make a few comments on the meeting in Basle this past weekend, which he had attended along with Messrs. Daane, Hayes, and Coombs. He had found the meeting to be particularly pleasant; as the Committee knew, he had been honored on the eve of his retirement along with Dr. Karl Blessing, who had just retired as President of the German Federal Bank. It was also pleasant to be able to report that the System's relations with foreign central banks were good, and that both Mr. Coombs and Mr. Solomon were recognized as outstandingly capable individuals who reflected credit on the Federal Reserve.

In the substantive discussions, the Chairman continued, the atmosphere had been good and the general attitude of the participants constructive. He had been interested in noting some of the changes in circumstances of particular countries. Italy appeared to be faced with serious problems, including demands for unusually large wage increases. The Germans were disturbed

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by the heavy loss of reserves they had experienced since they had abandoned the previous parity for the mark, and the French were apprehensive about the outlook for the next six months. The British, on the other hand, were quite optimistic about the prospects for sterling. In his comments about the United States he had reported that inflation was not yet under control but that U.S. policy makers were doing what they could and that progress had been made in slowing the economy.

One other significant matter discussed was the problem of gold, Chairman Martin said. Of course, in the United States primary responsibility in that area lay with the Treasury, and the System's delegation to the meeting had sought to make the Treasury's position clear. The British, Dutch, and Swiss representatives had indicated that they would like to revive the gold pool arrangement to provide a "partial" floor under the market price. In his judgment their arguments were not very persuasive. Mr. Daane did most of the speaking for the United States; he (Chairman Martin) and Mr. Hayes limited themselves to a supporting role. In his judgment Mr. Daane had handled a difficult situation extremely well.

The Chairman noted that after the meeting he had indicated to reporters that the United States was opposed to establishing a floor under the market price of gold. At the meeting itself it was understood that there would be no intervention in the gold market

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in the near term unless there was a dramatic decline in the price; and even then there would be intervention only after consultations. The two-tier system appeared to be well established at this point, and in his opinion Under Secretary Volcker had performed a very difficult task in achieving agreement with the South Africans.

The Chairman then invited Mr. Daane to comment on the Basle meeting and on the earlier meeting in Rome at which the gold problem had been discussed.

Mr. Daane said he thought Chairman Martin had covered the developments at Basle very well--except that the Chairman had been unduly modest regarding the support he (Chairman Martin) had given in the discussions on gold. Perhaps some further comment was warranted on the earlier discussions in Rome and the subsequent decisions in the IMF on the arrangements regarding South African gold. The Rome discussions had taken place about a month ago, beginning on Saturday, December 13--a few days before the last Committee meeting--and continuing until the early morning hours on December 16. The participants included Under Secretary Volcker and other officials of the U.S. Treasury, Mr. Dale from the Fund, and Mr. Daane; and, from the South African side, their permanent Secretary for Finance, Mr. Browne,

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Governor de Jongh, and others. Those discussions had been followed by the IMF decisions and understandings between the Fund, the South Africans, and the United States that were embodied in documents that had now been made public.

The principal elements in the decisions of the Fund and the related understandings could be viewed as fourfold, Mr. Daane continued. First, the South Africans obtained an official floor of \$35.00 for their new production when they needed to sell for balance of payments reasons. Secondly, they obtained a channel assuring that their gold could move into the international monetary system under certain conditions. There were two criteria for such a move. One was a price criterion--if the price dropped below \$35 and their foreign exchange needs required, they could sell gold to the Fund at \$35 less a handling charge. Also, if the deficit in their balance of payments outran their new production, after all of their new production had been sold into the market they could sell gold to the Fund to meet their needs. In sum, if they had a sizable enough deficit or if there was a price drop to or below \$35, there could be an inflow of gold into the monetary system.

From the point of view of the United States, Mr. Daane said, there also were two significant gains. One was a real

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strengthening and generalizing of the two-tier system, with even the South Africans recognizing its existence, albeit reluctantly. The second was the assurance that South Africa would sell its gold normally into the market in an orderly and continuous way. There was one other aspect of the agreement revealed in the Fund documents. The South Africans had a small "kitty" that was comprised of the last of the gold stock they had on hand in March 1968, at the time of the establishment of the two-tier system. Specifically, it was the amount they had on hand in March 1968 less all of their subsequent sales to monetary authorities. What remained could be used as they saw fit to defer market sales to the extent of \$35 million per quarter. From what he understood, however, the so-called "kitty" probably would be exhausted by or before the third quarter of 1970.

Mr. Daane commented that in his judgment the agreement and the decisions of the Fund represented a gain for the stability of the international monetary system, in that there was a definite and explicit understanding that there would be no direct purchases of South African gold by monetary authorities. There was only one abstention, by the French. One loose end, however, related to central bank buying in the market. Clearly no one had in mind buying if the market price were above \$35; but there had been no explicit discussion in Rome or in the Fund of what would happen if the market price went below \$35. Chairman Martin had capsuled

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very well the views expressed on the point at Basle. The feeling of the United States was that, with the South African arrangements in place, there was no logical reason for any central banks, individually or collectively, to buy in the market.

In response to the Chairman's invitation to comment, Mr. Hayes said he would add a footnote regarding the Basle discussions of market purchases of gold. It was his understanding that while the subject might be held in abeyance it was not regarded as closed.

Mr. Daane agreed, noting that the discussion might be resumed at the Basle meetings during the next few months.

Chairman Martin commented that he would expect the matter to be discussed seriously only if there was a sharp decrease in the market price of gold.

Mr. Hayes then said he might touch on two additional points regarding the Basle meeting. First, the subject of interest rates in the Euro-dollar market was still of much interest to the governors, and several had raised the question of whether it was likely that there would be a diminution of pressures in that market. Secondly, he had been quite interested in Governor Rasminsky's comments on the Canadian situation because it was similar to the situation in the United States in important respects--including high interest rates, tight money, and a balanced budget. However, both the size of their recent wage settlements and their unemployment rate were greater than in the United States. The Governor

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had questioned whether the Canadian authorities had adequate means to deal with cost-push inflation. A commission established to deal with the matter was getting little cooperation from labor.

Mr. Mitchell said he had a question concerning the consequences if over the next few years the South Africans did not sell all their gold on the market and industrial demands did not drive up the price, so that some volume of their gold entered the international monetary system. Under such circumstances, would there be any way the United States could defend against buying any of that gold?

Mr. Daane responded that the flow of gold from South Africa to the monetary system would be through the Fund, and the specific procedure for allocation had not been determined yet. It was not clear whether the United States would automatically get a specific percentage share or whether it would have the right to reject it. In short, the question had not yet been fully resolved.

Chairman Martin commented that when the time came to activate additional SDR's the amounts would be related to developments with respect to monetary gold. It was clear that up to the present time there was no intention to demonetize gold but only to supplement it.

Mr. Hickman remarked that he was somewhat concerned about the long-run implications of the agreement. Did it carry a time

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limit? Would there be opportunities for the United States to re-examine it?

Mr. Daane replied that there would be a review in the event of a major change in circumstances and in any case after five years. He thought the general expectation at this time was that by the end of a three-to-five year period the market situation would be such as to make the agreement somewhat academic.

Mr. Bopp commented that there were many unknown factors in the situation. One could not predict what new mines might be discovered in the next five years. On the other hand, the cost of gold production might become so high over that period that no one would want to produce it.

Mr. Brimmer said he presumed that the other producers of gold--including the United States--would have to sell their output in the market. If so, South Africa would be the only producer with the benefit of a floor.

Mr. Daane replied that the question of where the agreement left the other gold producers was a little cloudy. It was correct that the Canadians and other producers did not quite have the same option as South Africa. The whole matter had been left in the hands of the IMF, and if any other producer wanted to raise the issue it would be discussed in the Fund. But, in fact, the other producers apparently had not done so.

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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 December 16, 1969, through January 7, 1970, and a supplemental report covering the period January 8 through 14, 1970. Copies of both reports have been placed in the files of the Committee.

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

The financial markets over the interval since the Committee last met were subject to the usual seasonal churning characteristic of the period. Money center banks were under special pressure, as usually occurs in December, and with two holiday-shortened weeks in the period, the money market was subject to special stresses and strains. And, with bad weather prevalent over most of the country, float was subjected to wild gyrations that proved impossible to forecast, and as a result we were seldom very sure of what the over-all bank reserve situation really was.

No one in the bond market appeared sorry to see 1969 draw to a close. While there is widespread hope that 1970 will prove to be a better year, there is concern that an inadequate fiscal policy will require continued monetary restraint well into the year. Thus, the market will be appraising most carefully the President's budget message later this month. There is also concern about the volume of corporate, municipal, and Government agency financing likely to be forthcoming in the weeks ahead, and the Treasury's February refunding will provide an additional test of the market. There were some further signs of economic weakness, but with unemployment continuing at a low level and prices continuing to rise, there were few in the market who seemed to feel that the anti-inflationary program was really beginning to bite.

Nonetheless, the corporate bond market got off to a good start with its heavy January calendar, and yields on new issues were as much as 1/2 percentage point below the record highs of early December. The municipal bond market, too, recovered from the depths of its early December despair. Both of these markets--and other debt markets as well--have depended heavily on buying by small investors. There is considerable doubt as to how long individual investors can sustain the markets, and there is concern over the implications for the thrift institutions of such a shift in the investment preferences of individuals. So far, while there were heavy outflows from savings institutions over the year end, the experience has not been disastrous--although there is some worry that the outflows may continue as January progresses.

In the Government bond market, prices fell to successive record lows in the second half of December as dealers--concerned about the fiscal outlook and its implications for monetary policy--backed away from tax sales of coupon issues. In addition, bank portfolio managers were particularly distressed by the capital gains provisions of the final tax bill requiring them to count capital gains as ordinary income, and this concern continues to weigh on the Government note and bond market. While prices on Treasury notes and bonds have rebounded somewhat in the new year, yields on intermediate-term issues are generally 25 basis points or more above levels prevailing at the time of the last meeting of the Committee. The imminence of the Treasury refunding is of course proving to be an inhibiting factor in the Government note and bond market.

Treasury bill rates, in contrast, declined on balance over the period. There was, however, substantial upward pressure on bill rates in the latter part of December, as dealers who had increased inventories despite high financing costs found demand less than had been expected. In this atmosphere the auction rate on both three- and six-month bills reached an all-time high of 8.10 per cent on December 29. In last Monday's regular weekly auction, however, average rates of 7.84 and 7.78 per cent were established for three- and six-month bills, respectively, 8 and 14 basis points below rates established in the auction just preceding the last Committee meeting. It should be noted that at the high rates reached in late December a strong demand emerged from a

wide variety of investors, including individuals shifting into higher yielding bills from other investments. Reflecting this disintermediation, noncompetitive tenders in the weekly auctions have been very high--amounting to \$1 billion in the auction on January 5 and to even more last Monday. In Monday's auction the System redeemed \$150 million of its \$663 million maturing January 15 bills in order to accomplish some of the reserve absorption that the projections indicate will be needed in the weeks ahead.

Open market operations over the period had to be conducted flexibly with a view to accommodating the seasonal pressures in the money market, the seasonal demand for excess reserves on the part of the banking system, and another burst of Treasury bill sales by the German Federal Bank. In addition, float was subject to wild gyrations that proved impossible to predict; daily misses in estimating float of \$1/2 billion to \$1-1/2 billion were not uncommon, and there was no consistent pattern in the direction of the projection misses.

Thus, in the statement week ended at the year end--with pressures centering on the money market banks and banks anxious to get their positions in order so as to avoid borrowing on the statement date--the Desk found it necessary to provide reserves through repurchase agreements even though net borrowed reserve estimates were in the \$400 million range. Given the tightness in the money market, we felt that a relatively low net borrowed reserve number would be properly interpreted by the market as the product of year-end churning rather than as any shift in policy. Our willingness to supply reserves was strengthened somewhat by the then apparent weakness in the monetary aggregates, but given the pressure in the Federal funds market our actions would probably not have been far different even if the projections had been somewhat stronger. The low net borrowed reserve figure for the week ended January 7--\$648 million as originally published--was not deliberately intended, but resulted from a huge bulge in float in the last two days of the statement week. It is hard to see how it could have been avoided, however. Until late on Tuesday, the Federal funds market was under considerable pressure with the rate ranging from 9-1/2 to 10 per cent, and net borrowed reserves were projected in the \$1-1/2 billion range. On Wednesday, when the funds market eased up, matched sale-purchase agreements were used to absorb excessive reserves, but not in a volume large enough to offset increased float. The appearance of such low net borrowed reserves for a

second week in a row caused some speculation that policy might have been eased somewhat. No great damage appears to have been done, but in view of the sensitivity of the market to any hint of a policy change operations were aimed at achieving a more normal net borrowed reserve range in the statement week ended yesterday.

Looking ahead, projections indicate a need to absorb reserves in the weeks ahead. Fortunately, an improvement in the basic reserve position of the money center banks should be under way and this should take pressure off the Federal funds rate and short-term interest rates generally--barring any unforeseen developments. Consequently, I would expect that the blue book^{1/} specification of an 8-1/2 to 9-1/2 per cent Federal funds rate should again be compatible with net borrowed reserves in a \$900 million to \$1.2 billion range.

The Treasury, as you know, monetized \$1 billion in gold and \$200 million in SDR's on January 8. The reserve impact of this action was offset--as Mr. Coombs noted--by the repurchase by the Treasury of foreign exchange warehoused earlier with the System, and by keeping the proceeds of the SDR monetization unused in a special Exchange Stabilization Fund account at the Federal Reserve Bank of New York. As I understand it, the Treasury plans to monetize SDR's on a regular basis, although it is not clear whether they will continue to build up the special account. If they do build it up, any reserve impact of the SDR monetization would come only when the ESF put these funds to work.

As far as the monetary aggregates are concerned, money supply, as the blue book indicates, finally turned in a stronger performance in December than had been expected, increasing at a 2 per cent annual rate instead of declining in the 3 to 6 per cent range which had been projected at the time of the last meeting. The credit proxy declined at only a 1/2 per cent annual rate, also less than had been expected and, after adjustment for all nondeposit sources of funds, actually rose slightly over the month. The meaningfulness of the numbers, however, is clouded by the fact that the more robust performance was due to a jump in private demand deposits in the last week of December--a jump which may have been only

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

illusory. In fact, over much of the period the money supply appeared to be declining more rapidly than had been projected and the credit proxy appeared to be declining at the deeper end of the 1 to 4 per cent range projected at the time of the last meeting.

Looking ahead, in January no change is projected for the money supply while the credit proxy, including Euro-dollars, is projected to decline at about a 3-1/2 per cent annual rate. Total bank credit could turn out somewhat stronger than this would imply, however, if bank-related commercial paper undergoes a substantial rise, as appears likely. As you know, several large banks who had abstained from that market have made the decision to go ahead and others appear on the verge. Should the Committee adopt a two-way proviso clause in the directive, I will continue to assume--unless otherwise instructed--that, while the Committee would prefer to see a modest rise in the aggregates, the rates of change projected in the blue book are acceptable. This implies that the proviso clause--even keel considerations permitting--would be implemented more readily if the aggregates are turning out weaker than expected than if they are turning out stronger.

As the Committee knows, the Treasury will be announcing the terms of its February refunding on or about January 28. In addition to the \$4.4 billion of Treasury bonds maturing February 15, of which \$3.9 billion are held by the public, there is a \$2.3 billion issue maturing March 15 which might well be prerefunded. As yet there has been little market discussion of the possible terms of the refunding. Given the current emotional state of bank portfolio managers with respect to investments in Government securities, as well as the general state of the market, the Treasury is apt to have a difficult task in setting the terms of the refunding. The System holds only about \$108 million of the February maturity and \$574 million of the March maturity. Should the Treasury decide to offer more than one issue in exchange for the maturing issues, I would plan to split the System's subscription among the issues offered roughly in proportion to the expected public subscription.

Finally, I might note that on January 7 Blyth and Company announced that it was winding up its activities in the Government securities market, and yesterday the Desk terminated its trading relationship with the firm. Another recent withdrawal from the market is that of D. W. Rich and Company, which ceased

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its operations in Government securities at the end of 1969. The System had terminated its trading relationship with this firm early in 1969, due to its dwindling volume of activity.

Mr. Daane asked the Manager for his assessment of how the market might respond if the Desk were to absorb reserves a little less aggressively or to implement the proviso clause more readily in the case of a weaker than projected credit proxy.

Mr. Holmes replied that there was already in process a seasonal shift toward easier conditions in the Federal funds market and in short-term credit markets generally. That trend could, of course, be overridden by outside developments, but if it were not the Federal funds rate might be expected to decline somewhat from its year-end levels if net borrowed reserves were moved back to the range prevailing prior to the last few weeks. In addition, Treasury bill rates could decline on balance in this period, particularly if seasonal demands continued to be supplemented by demands from small investors.

Mr. Brimmer observed that it might prove useful for any System policy move to involve some action with respect to Regulation Q ceiling rates. He wondered how the Manager would propose to operate in meshing any regulatory action that might be taken with goals of open market policy as specified in the blue book.

Mr. Holmes said it was difficult to reply without knowledge of the specific regulatory action that might be taken. If there were increases in Regulation Q ceiling rates large

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enough to permit banks to compete for funds, time deposits could expand rapidly. That, of course, would mean greater strength in bank credit for any given set of money market conditions.

The rate of growth in bank credit would depend in some measure on whether banks decided to cut back their borrowings in the Euro-dollar and commercial paper markets as their time deposits expanded.

Mr. Brimmer asked how banks might be expected to respond to relatively moderate increases in Regulation Q ceiling rates on CD's of \$100,000 and over--increases that did not permit banks to compete aggressively for funds.

Mr. Holmes replied that if the action permitted only limited CD inflows banks would probably go ahead with present plans to raise funds in the commercial paper market, provided the Board did not impose other limitations in that area.

Mr. Hickman observed that the nature of bank reactions to a change in Regulation Q ceilings would be closely related to the Committee's decisions in the open market area. If, for example, a moderate increase in the ceilings on large-denomination CD's was coupled with an open market policy that fostered declines in bill rates, there might be rapid growth in CD's outstanding; but if prevailing conditions were maintained in money and short-term credit markets, the same ceiling rate increases might result in no growth in CD's.

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Chairman Martin noted that the Reserve Bank Presidents had been advised by wire that the Board would welcome statements of their views on Regulation Q ceiling rates at today's meeting. No doubt the subject would be pursued in the course of the go-around.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period December 16, 1969, through January 14, 1970, were approved, ratified, and confirmed.

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

Mr. Partee made the following statement concerning economic developments:

With the preliminary Commerce estimates of GNP for the fourth quarter--scheduled for public release tomorrow--we now have additional evidence that economic activity has ceased to rise in recent months. In current dollars, the fourth quarter GNP increase was only \$10 billion--markedly smaller than the \$17 billion average of the first three quarters of the year. And there was no growth at all in real terms. The GNP data now seem more compatible with the industrial production index which dropped one half point further in December. Adjusting for the GE strike, the downtrend in the index over the five month July-to-December period has been at the moderate but significant annual rate of about 4 per cent. Growth in nonfarm employment also has slowed notably since mid-year; again making an adjustment for strikes, the increase in the second half amounted to 375,000, versus 1.5 million in the first half. Employment in manufacturing has declined slightly on balance since August.

It seems evident that softness in business will continue in the early months of 1970, but it is not nearly so clear how much additional weakness may develop or how long the period of adjustment is likely to persist. Most of the indicators are not yet signaling any very significant recession in activity and there are important elements of underlying strength that seem to point to only a relatively brief pause in economic expansion. These considerations have led us to project GNP increases in the first and second quarters in the \$8 - \$10 billion range, which would imply only a slight decline in real activity, to be followed by substantially larger gains in nominal GNP and resumption of real growth at a moderate rate in the second half of the year. But it is important to note that our projection postulates no sharp correction in inventory levels, a gradual leveling off but no reversal in the upward trend of business capital spending, and a substantial shift toward stimulus in the Federal fiscal posture. We also assume the beginnings of a recovery in housing and faster growth in State and local government capital spending after mid-year, based on an easing in financial market conditions that would have to begin soon if these projections are to be realized. On the other hand, we have assumed continuation of relatively conservative consumer spending attitudes throughout the forecast period. Important misses in any of these areas would have significant implications for our projected pattern of over-all development of the economy.

As for business inventories, it is apparent that adjustments in some lines are already under way. The increase in book values of stocks dropped sharply to an \$8.3 billion annual rate in November, reflecting partly output adjustments in autos and other consumer durables as well as the GE strike. Though no data are available, the further dip in industrial output last month suggests that there may have been a continuation of relatively low inventory accumulation rates. The question at issue is how much further the inventory correction might go in early 1970. Automobile and consumer durables inventories remain burdensome, and there has been little if any adjustment as yet in stocks of industrial materials or in the defense industries. The ratio of stocks to unfilled orders in durable goods manufacturing has been rising fairly sharply since last spring, and inventory-to-sales ratios are on the high side though not astonishingly so. On the other hand, businessmen still seem confident about longer-run market prospects and prices of goods

are still inflating rapidly, making earlier additions to inventory look like a good buy. Taking all this into account, we are projecting reduced inventory investment extending into the summer of 1970, but with rates of accumulation remaining well above the zero line.

All of the private surveys of business capital spending plans this past fall have indicated a further substantial rise in 1970, and this is also true of the Commerce-SEC first look at the year ahead. This comprehensive survey reports that plans are for a sharp further rise in the first half--dominated by utility and communications outlays--with little additional increase in the second half of the year. It is hard to fault these findings, especially in view of the continued pressure on capacity in such areas as utilities, the increasing emphasis on cost control, and the strong inflationary bias on the part of most capital goods purchasers. And yet it does seem possible that the combination of falling profits, currently soft product markets, and very tight external financing conditions could induce more and more spending stretchouts and cancellations in some of the more cyclically sensitive industries. Our projection follows a middle course, shading downward the increases indicated by the official survey but not really allowing for any marked shift in business thinking as to what is desirable and can be financed.

Recent consumer buying behavior continues to confirm the belief that consumers are in a conservative mood. New car sales have fallen off progressively since September, to a 7.7 million annual rate for domestic makes in December and well below that in the first 10 days of January. Total retail sales have been essentially flat since last spring with the advance December report showing no change from November. Consumer attitude surveys have reported further deterioration over the fall, with earlier concern about inflation and tight money now buttressed by increased apprehension as to job and income prospects. Accordingly, and because the reductions in the surtax seem unlikely to carry through fully to spending--just as introduction of the surtax did not inhibit consumption proportionally--we are projecting a rise in the personal saving rate in the first and successive quarters of 1970. If consumers suddenly turn more bullish, considerable additional consumption could be generated and the saving rate would tend to decline. But this seems unlikely to us before late in the year, given the general economic outlook and the continuation of substantial price inflation.

There can be no question but that fiscal policy will be turning more stimulative as the year progresses. The surtax reductions in January and July, the retro-active 15 per cent social security increase coming in April, the upward bias stemming from higher pay and the thrust of programs already in place insure that this will be the case. Outlays in the unified budget now seem certain to exceed the \$193 billion ceiling for fiscal 1970 by a sizable margin, and the 1971 total probably will top \$200 billion. But the near-term stimulative effects of the tax reform bill did not turn out to be as large as seemed possible, and even probable, just a month ago. And the President's intent to hold budget expenditures down has been strongly and publicly reiterated in recent weeks and days, as the decisions in that respect were in process of being made. We hope to present a new projection and chart show, incorporating the new budget estimates, at the next meeting of the Committee.

Based on present information, however, I believe that our current economic projection for 1970 is in the ball park. Economic activity has leveled off, and I expect it to remain so well into the year. There are substantial risks of error in both directions, but I believe that the chances we have understated the weaknesses and overstated the strengths, given our policy assumptions, are at least as high as the other way around. Pressures on costs and prices remain intense, but there is not much more that monetary policy can reasonably do about this once the excessive demand conditions aggravating the problem have been curtailed. Accordingly, I continue to believe that the Committee should consider taking the first steps toward a monetary posture that will be viable in the longer-run environment calling for continued restraint that we appear to face. Such a policy should be aimed at encouraging moderate growth in the monetary and banking aggregates as the year progresses. Toward this end, it seems to me that the experience of recent weeks and months makes clear that both an upward adjustment in Regulation Q ceilings and a careful and gradual easing up in the System's exceptionally restrictive open market policies are needed.

Mr. Hickman said he was disturbed by Mr. Partee's proposal for an upward adjustment in Regulation Q ceilings. He agreed with

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Mr. Partee that it would be desirable to encourage growth in the monetary and banking aggregates at some small positive rate. However, he felt that the first policy move toward that end should be one that did not carry an announcement effect and thus would not be likely to produce marked changes in expectations about the stance of policy. In short, he favored confining any move at this time to open market operations.

Mr. Partee remarked that he had suggested an increase in Regulation Q ceilings as well as some adjustment of open market policy because he thought the former was likely to prove necessary if there was to be any significant growth in bank credit in the period ahead. Providing more reserves through open market operations might result in stronger growth than otherwise in the money supply; but unless market rates were forced down to sharply lower levels, he would not expect any significant amount of reintermediation by banks. In his judgment, some expansion was desirable in both bank credit and the money supply.

Mr. Hickman expressed the view that an increase in private demand deposits and the money supply was likely to be associated with some increase in bank credit. His concern was that the System might move from a posture of extreme monetary restraint to one of extreme ease--overdoing the shift, as it had at times in the past--if it acted both on Regulation Q and on open market policy now. Moreover, limiting the initial policy move to open market operations

might result in having a better basis for determining the appropriate scope of any subsequent move with respect to Regulation Q ceilings.

Mr. Keir made the following statement concerning financial developments:

A month ago, as financial analysts looked ahead to the new year, the extremely low state of liquidity in the economy, the very heavy forward calendar of new security offerings, and the widespread anticipation of record reinvestment-period attrition at depository institutions led many to wonder whether sharp further rate increases and serious financial dislocations were in store for early 1970. The fact that market interest rates have actually turned down in early 1970 does not belie the seriousness of this earlier concern.

Heavy post-interest crediting transfers of funds from depository institutions to market securities have themselves been a major factor exerting downward pressures on market yields--and this influence is now beginning to taper off. Survey data from the Federal Home Loan Bank Board indicate that net outflows from the savings and loan associations amounted to \$1.3 billion during the December-January reinvestment period. The major New York City mutual savings banks--where the bulk of withdrawals for that industry was expected--experienced reinvestment period losses totaling about \$325 million. At commercial banks, a very preliminary estimate for the first two weeks of January suggests that net drains from time and savings accounts other than large-denomination CD's probably totaled well over \$1 billion, much more than in other years and also more than in the comparable weeks of July.

Attrition at the thrift institutions was likewise much larger than in any other December-January reinvestment period. However, because it was substantially less than feared--by nearly \$700 million at the S&L's--a sense of relief that things were not worse helped to buoy Federal agency and related markets. Contrary to earlier market expectations, the January financing of the Federal Home Loan Banks was no larger than in other recent months. And there now appears to be little prospect that the FHLBB will have to resort to direct borrowing from the Treasury.

A key question yet to be answered is whether depository institutions will continue to experience sizable

net withdrawals over coming weeks, as in the July and October post-interest crediting periods. The pattern of outflows experienced to date suggests that they will, although in substantially reduced volume. Nevertheless, while the depositary institutions now seem to have weathered the worst of this latest concentrated burst of disintermediation, it is clear that the outflows have been large enough to deal the mortgage market another serious blow.

Transfers from depositary institutions were not the only source of increased demand for market securities that contributed to recent yield declines. Other market-oriented investors more influenced by expectational factors have also been active and should become increasingly so if expectations about policy changes intensify. On the other hand, most major types of institutional investors have not been very aggressive buyers of bonds recently, due partly to the fact that available funds have already been substantially committed. As flows from depositary institutions taper off, the course of securities market rates may, therefore, become increasingly sensitive to expectations and hence less reliable as a measure of underlying supply-demand conditions.

With nonfinancial activity tending to slow down, we keep looking for signs of slackening credit demands as well, but to date it is difficult to identify clearly any such change. The estimates on forward security offerings suggest no diminution in the prospective weight of capital market financings. While business loan growth apparently did remain moderate in December, the statistics are so confused by unusual year-end adjustments that it is difficult to tell whether the impression that loan growth has been small is valid, let alone whether such slowing as may have occurred reflects demand or supply considerations. Some dealers report a little moderation in the supply of commercial paper being offered by businesses, but again this may simply reflect the fact that the structural growth of new names in this market has slowed down.

Summing up, although we have managed to get through turn-of-the-year pressures more easily than some had feared, it is hard to see that any basic change has yet occurred in the underlying supply-demand situation that led to so much strain on credit markets in late 1969. At this point, therefore, any moderation of financial conditions of more than a temporary nature would have

to come either from some reduction in the severity of monetary restraint or from further weakening of the economy. Since there is a substantial risk that the economy may slow more rapidly than projected, it would seem particularly important at this time to avoid any further intensification of the liquidity squeeze.

In these circumstances, the prudent prescription for monetary policy would seem to be to adopt an operating approach that would lessen slightly the severity of monetary restraint by encouraging moderate growth in the monetary and banking aggregates.

Over the last quarter, maintenance of the prevailing money market conditions specified in the blue book for alternative A of the directive^{1/} did produce a modicum of growth in the aggregates--around 1 per cent for the money supply and about 2 per cent for the bank credit proxy including both Euro-dollars and other non-deposit sources of funds. However, the blue book documents our judgment that continuance of the alternative A specifications over the current quarter would likely lead, in a weakening economic environment, to no growth or to some decline in the aggregates. Thus, the appropriate directive to achieve the stated goal would appear to be either alternative B or C.

As you have probably noted from the blue book, the money market specifications of alternative B and the money market results expected to flow in the short-run from adoption of alternative C are virtually the same. This suggests that it would make little difference for the inter-meeting period which alternative is selected. But this would be so only if the staff specification of expected relationships between money market conditions and monetary aggregates turns out to be substantially correct. Alternative C is designed, in effect, to deal with the possibility that the blue book specification is wrong. If alternative B were adopted and the economy turned out markedly weaker than the staff forecast, efforts by the Desk to maintain even the lower ranges of money market conditions specified could lead to significant shortfalls in the money and credit estimates. On the other hand, if the economy proved to be stronger than forecast, the reverse could be true.

Given the desire to encourage some--but not too much--growth in the monetary aggregates during an

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

uncertain period when adherence to a money market conditions target might make for wider-than-usual misses in the aggregates, the logic of directing attention specifically to desired aggregate targets is clear. It may be argued that this can also be done through closer attention to variations in the aggregates contemplated by the proviso clause. Such a reformulation of the proviso would underline the importance of growth in the aggregates. And in addition, given the possibility that changes in Regulation Q ceilings could make increases in bank credit difficult to interpret, the proviso might direct attention to changes in the money supply as well as bank credit.

In the last analysis, it seems to me that the choice between alternatives B and C must be made in terms of the approach that most clearly communicates the Committee's intent to the Manager. Alternative C requires the Committee and the Manager to focus more directly on a quarterly projection of both monetary and banking aggregates, which would seem to be desirable from the standpoint of achieving moderate growth in these aggregates. It would seem equally possible to encourage growth in the aggregates by instructing the Manager to pay closer attention than before to the proviso--perhaps adding money supply to the bank credit specification--and to vary money market conditions more widely in striving to accomplish this end. But if the Committee wishes to publicize its increased emphasis on the aggregates, I can see no overwhelming practical obstacles for the Manager in the alternative C approach, provided it is understood that the target numbers are apt to be missed frequently, and sometimes by large and unexpected amounts.

Mr. Keir added that the most recently available data, although still preliminary, suggested that the money supply was remaining stronger following the bulge at year end than had been projected in the blue book. Continuation of that pattern could mean some significant growth on average in the money supply in January. On the other hand, the performance of time deposits now seemed likely to be quite a bit weaker than anticipated at the time the blue book was prepared. On balance, it now appeared that the bank credit proxy would be somewhat weaker in January than projected.

Mr. Daane referred to Mr. Keir's comment that the continuance over the current quarter of the money market conditions specified in connection with alternative A of the directive drafts was likely to be associated with no growth or some decline in the monetary aggregates. He (Mr. Daane) wondered if that projection took into account the possibility of a change in Regulation Q ceilings; and if not, how the projection would be modified if it were assumed that the ceilings would be raised by an amount large enough to be meaningful.

Mr. Keir replied that the projection assumed no change in the ceilings. How it would be modified obviously would depend on the specific regulatory action assumed--the more competitive banks were permitted to be in the market for funds, the greater the growth in the aggregates that would be expected. He would stress that such growth would represent a process of reintermediation, and to a large extent would be at the expense of flows of funds through other channels. However, reintermediation no doubt would be associated with some easing in financial markets generally, since the frictions created by disintermediation would be removed.

Mr. Maisel asked whether the Manager thought an increase in the Q ceilings would produce a change in expectations that would make it difficult to maintain prevailing money market conditions, assuming the Committee adopted alternative A today.

Mr. Holmes replied that such an outcome was possible. However, he doubted that the shift in expectations would be so great

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as to make it difficult to maintain money market conditions within the ranges specified in the blue book.

Mr. Hickman asked whether an examination of historical experience might not offer clues as to the probable market response to a change in the Q ceilings.

Mr. Partee noted that the current situation appeared to be unique in a significant respect--the existing Q ceilings were so far out of line with market rates that they could be raised appreciably without restoring the competitiveness of CD's relative to going rates on market instruments. Accordingly, the relevance of past experience to the current situation probably was limited.

Mr. Keir added that past changes in Q ceilings often had been coupled with discount rate increases, so that the effects of the former could not be isolated.

Mr. Brimmer observed that in a review he had made last summer of the market's responses to changes in Q ceilings since December 1965, he had found that banks tended to react quite quickly. He agreed, however, that circumstances were so different at present that past experience was not necessarily relevant.

Mr. Brimmer then said that the distinction drawn between alternatives A and B--both in the blue book and in Mr. Keir's presentation today--was quite clear, but the distinction between alternatives B and C was less so. Both B and C were consistent

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with the view that a shift toward slightly less restraint was desirable now, and both called for about the same money market conditions in the coming policy period. Evidently the case for alternative C rested mainly on the arguments that the Committee should consider the performance of the aggregates over a longer period such as a quarter, and that it should commit itself now to take a series of easing actions extending over the quarter. He wondered why the Committee should make so significant a change in the way it conducted its business at this juncture--given the forthcoming change in System leadership, the expectation of a report from the committee on the directive which Mr. Maisel was chairing, and the imminence of the Administration's Budget Message and Economic Report--particularly when the same short-run results could be achieved under alternative B.

Mr. Keir commented that the staff was not making any recommendations as to the choice between alternatives B and C; it had presented the latter alternative in an effort to be responsive to views expressed in the past by some Committee members. It was true that there was little difference between the two with respect to money market specifications for the coming policy period, and that alternative C contemplated that some further easing in money market conditions would be required

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over the course of the quarter in order to attain the desired growth rates in the aggregates. Presumably the Committee would take a fresh look at the situation at its next meeting. Focusing on the behavior of the aggregates over a quarter was advantageous because month-to-month fluctuations were often so marked that it was difficult to judge from monthly changes whether the aggregates were on target with respect to the longer run.

Mr. Partee referred to Mr. Brimmer's comment that adoption of alternative C involved a commitment by the Committee to a series of easing actions. He (Mr. Partee) would not interpret adopting C as implying any commitment; he thought the Committee would remain free at subsequent meetings to reach any decisions on policy that it thought proper on the basis of the situation existing at the time. He would prefer to describe alternative C as involving a "plan of action."

Chairman Martin said he also had not interpreted alternative C as involving any commitment regarding future policy actions.

Mr. Hickman noted that the blue book projections under both alternatives A and B implied declines in the credit proxy in January and February. Perhaps one might say that by adopting alternative C the Committee would be committing itself to the proposition that over the longer run some positive rate of expansion in bank credit--and the money supply--was desirable.

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Mr. Daane asked whether there might not be some moderate expansion in the aggregates even if alternative A were adopted--perhaps as a result of a meaningful increase in Regulation Q ceilings or of a substantial rise in bank-related commercial paper outstanding.

Mr. Keir replied that such an outcome under alternative A was possible.

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

This morning I would like to call your attention to recent and prospective developments in U.S. foreign trade, and consider their implications for policy. Before going to these matters, I might make one comment on balance of payments events of the past fortnight, namely that some of the extraordinary movements of funds that occurred in the last week of 1969 were reversed in the first week or so of the new year.

If we leave out of account the receipt from the IMF of \$867 million of Special Drawing Rights, the liquidity balance showed a deficit in the week through January 7th of \$1 billion, following a surplus of over \$2 billion the week before. We surmise that a considerable part of the large amount of U.S. corporate funds that came in at the year end moved out again. Probably much of this outflow went to the Euro-dollar market, either directly or through direct-investment subsidiaries abroad, in order to repay loans or to reconstitute corporate liquid balances abroad drawn down the week before. As a result--and this we know for sure--the U.S. banks' borrowings from their foreign branches, which had been reduced by nearly \$1-1/2 billion in the course of the previous week, rose again, to the extent of \$800 million. Unlike the many times when increases in borrowings from branches have been associated with movements of funds out of other currencies into Euro-dollars, this time movements of the latter kind do not seem to have been an important factor. In any event, we had a fairly large official settlements deficit in the first week of 1970. It may be

that the flow of funds out of German marks, which was extremely heavy all through the last quarter of 1969 following the mark revaluation, and which benefited our balance of payments on both bases during that period (including the final week of the year), is now tapering off.

It is becoming increasingly clear that the U.S. foreign trade balance in recent months has not developed quite as favorably as we had hoped it might. Exports have been doing pretty well; agricultural exports have been above expectations and machinery orders have been on a strongly rising trend--though machinery shipments are lagging somewhat. But imports in November, instead of zigzagging down after the very high October figure, held up. For this reason, we have had to reduce a little our estimate of net exports in the fourth-quarter GNP accounts.

The trade outlook was reviewed again toward the end of last week by the interagency group of balance of payments specialists, and the prospects remain about as discouraging as ever. Taking into account services and interest and dividends as well as goods, the Federal Reserve staff projection of 1970 net exports carried in the last green book^{1/} at about \$3-1/2 billion still looks reasonable, given the assumptions we make about U.S. GNP.

In preparation for the WP-3 meeting that Mr. Solomon is attending today in Paris, the OECD staff reviewed the outlook for international trade and payments, paying particular attention to the degree of progress countries seem to be making toward reasonable goals. They took as a reasonable "interim aim" for the U.S. balance on goods and services a figure of \$6-1/2 billion, which is not quite as much as was achieved in 1964 and 1965. Their finding was that in 1970, despite a relatively favorable cyclical conjuncture, the United States would be further from its goal--in absolute dollar terms--than most other big countries would be from theirs, and they raised the question whether the United States has been experiencing "a gradual loss of competitiveness in the broadest sense" as a result of prolonged excess demand, and the further question of whether this effect

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

is likely to be reversible or not. The short answer, I am sure, is one I have often given this Committee: to achieve a viable equilibrium we are dependent to a great extent on additional actions by other countries that would serve to alter international price-cost relationships, but no cure will work without a marked slowing of price inflation in the United States.

The question before the Committee, of course, is how to proceed at this moment toward that goal of slowing the inflation of prices. Mr. Solomon last month spoke of the need "to persevere with a sustainable program of fiscal and monetary restraint." In general I would agree with those who think that in the end we will achieve the needed monetary restraint better if in one way or another the present pressures on bank liquidity are lightened a little. To my mind the essence of the matter is that monetary policy in the course of 1969 squeezed the liquidity of the banking system enough to bring a significant shift in bank lending policies. A further reduction of bank liquidity would be neither necessary nor desirable under present conditions--though conceivably by next summer it could again be needed.

Recent foreign trade information is of no use in making judgments about bank credit availability or even about the timing of a change in Committee targets, except that such information may be of some help in diagnosing the present state of the economy. Strictly speaking, the evidence relates to conditions two or three months ago. As of that time, the latest foreign trade statistics tend to confirm three propositions for which there is other evidence in the domestic economy. First, producers and distributors of consumer durable goods have been cautious in their inventory policies. For example, importers of foreign-type cars, reacting to disappointing sales earlier in the year, held down their imports last autumn so much as to prevent usual seasonal stock-building. Second, the business equipment industries have remained under pressure. For example, unfilled export orders for machinery were rising sharply last autumn as new orders accelerated while shipments increased more moderately. Third, business demand for certain materials and foodstuffs on which world markets are expressing a bullish outlook was strong enough last autumn to bring further advances in the value, even if not the volume, of metal imports, as well as a sharp rise in coffee imports.

To sum up, I would put the case for some gradual and moderate easing of bank liquidity not primarily in

terms of recent trends in output and demand but rather mainly in terms of the present state of bank credit availability. Any amelioration of bank liquidity, in whatever way it is brought about, should be kept small and experimental, not only because the domestic situation may look very different by next summer, but also because our international reserve position is highly vulnerable to an easing of U.S. financial market conditions in advance of some easing in Europe.

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:

As we enter the new year, we face the same perplexing economic outlook that has confronted us now for many months. Business is showing signs of a reduced rate of growth. While industrial production continues to decline and homebuilding continues to reflect the constricted availability of funds, the economic data continue mixed. Certainly unemployment has not become a problem. There are some elements of pronounced strength, notably in the areas of business capital spending and fiscal policy. Increased social security benefits and the reduced income taxes could bring a resumption of more than nominal real growth in the coming quarters.

Meanwhile, upward price and wage pressures continue unabated. Expectations of future inflation remain widespread and deeply embedded, despite the slower economic growth. In part this seems to reflect growing cynicism as to the ability or will of Government policy to deal effectively with inflation. Fiscal actions taken and initiatives not taken in the last few months have contributed importantly to this cynicism. At a time when a sizable Federal surplus is needed in fiscal 1971, it looks more and more likely that there will be a deficit unless tax increases are enacted. The Administration seems at long last to be thinking of requesting some additional tax revenue to remedy this situation; but the time is late and Congressional sentiment seems uncooperative. There is some danger that planned improvements in the budget, on the expenditures as well as receipt side, may turn out to be more apparent than real.

Developments in the gold and foreign exchange markets remain favorable to the dollar, largely because of

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extremely tight credit conditions in the United States. However, the longer-term outlook for the balance of payments remains discouraging, especially in the absence of progress on the inflation front.

The principal bank credit and money aggregates continue to show very slow growth rates, although the December performance turned out stronger than expected. For many aggregates the performance in the fourth quarter was clearly stronger than in the third. Of course, growth since midyear has been very modest in comparison with rather generous expansion in the first half of 1969 and the much more rapid expansion of the year 1968. Under other circumstances this might point to a need for some easing of policy. But I come to no such conclusion under present conditions. We have seen it clearly demonstrated in recent months that continuation of a highly inflationary economic expansion can be validated and financed with a minimum of growth in the conventional money and bank credit aggregates through a rapid expansion of nonbank credit. I see no reason to be concerned if only very modest growth of the aggregates continues some months longer, or until we have clearer signs that inflationary pressures are waning. And I am impressed by the strength of demands on the capital market and the effect of the huge volume of agency financing on rates and expectations.

We are getting all sorts of policy advice these days, even from some quite unexpected quarters. But it seems to me that fiscal policy, not monetary policy, is now on trial. This seems clearly to be a time for holding steady on the tiller, at least until the Budget Message and the President's Economic Report provide us with a clearer view of the Administration's fiscal strategy. The marginal reserve targets agreed upon at the last meeting appear to be appropriate for the policy period ahead. The subsiding of seasonal pressures may cause the bill rate to decline below 7-1/2 per cent, and open market operations should be expected to accommodate, but not to encourage, market rate movements in response to such an easing of pressures. Alternative A appears appropriate for the directive, including the acknowledgment of the even keel constraint and the two-way proviso. I believe that the proviso should be invoked on the tightening side only if developments deviate rather significantly from the projections, but I would not like to see the proxy, adjusted for changes in non-deposit liabilities, decline much more than now projected.

Alternative C has some superficial appeal, but on closer analysis it seems to me to represent just as much easing as alternative B, without a forthright statement to that effect. I might add that I am troubled by some of the same points that Mr. Brimmer has raised.

The Presidents have been asked to comment on Regulation Q. At our last meeting I favored some easing of ceilings for larger-denomination CD's concurrently with the implementation of the proposals for new regulations with regard to bank-related commercial paper. I would also favor some liberalization of ceilings on small savings if appropriate arrangements can be made with the other regulatory agencies. The objective of a liberalization of Regulation Q seems quite simple--to permit the banks to engage in the process of intermediation without the distortions caused by their attempts to find escape hatches in the Euro-dollar market, the commercial paper market, or elsewhere. But I must confess that when it comes to spelling out specific recommendations there are all sorts of problems. To be effective, any change in Q ceilings on large CD's must be big enough to be meaningful--to permit banks to compete with market instruments. Too small a change in Q ceilings would not have the desired effect, and it would run the additional risk of being interpreted by the market as a Federal Reserve prediction that interest rates are going to decline. I would not want to give out a signal that the market might interpret--wrongly--as evidence of an easing of System policy, particularly on the eve of a Treasury refunding and before the Budget Message. Too liberal a change in Q ceilings, on the other hand, could permit banks to expand credit more rapidly than we might like to see.

Any action to liberalize Q, it seems to me, should be coupled with some other action that would be clearly restrictive--such as bringing commercial paper under Regulation Q and also, now that legislation is in hand, under Regulation D. I feel rather strongly that CD's and commercial paper should be given equal treatment (and commercial paper issued by subsidiaries and affiliates equal treatment also). But the structure of current Regulation Q ceilings for CD's--with rates rising with maturity--is peculiarly unsuited to the commercial paper market where the shorter maturities dominate. Hence, any change in Q that would effectively give banks the option to issue either CD's or commercial paper would have to be radical--perhaps involving a single, relatively high rate for all maturities.

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As much as I hate to equivocate on such an important matter, the problems involved in choosing just the right rate to do the job we want to see accomplished--particularly with the Treasury financing so near at hand--lead me to counsel postponing action until after mid-February. This is perhaps easier to do now that the Board has announced that it will postpone action to bring commercial paper issued by bank subsidiaries under Regulations D and Q until February 26. I would see no harm, however, in announcing that holding-company commercial paper would be brought under Regulation D, and allowing the banks 30 days for comment.

Over the next month or so it may be possible to find Q ceiling rates for large CD's that we could be fairly confident would accomplish our objectives. If that proves impossible I would favor removing the ceilings altogether and finding some form of quantitative controls--despite all the administrative and philosophical problems that would involve--that would prevent bank CD's and commercial paper from expanding more rapidly than we wished.

What I have tried to do is to point up some of the major problems as I see them, and I must confess that the whole area is one in which it is exceedingly hard to form a clear-cut judgment at this time.

In spite of all I have said, if there is to be any relaxation of policy at this time I would rather have it come through a change in Regulation Q than through easier open market policy.

Mr. Morris said the evidence seemed clear to him that the economy was moving into a contraction phase. Thus far, the figures suggested that the correction would be modest in amplitude--not of true recession proportions. Nonetheless, he thought it was important that the change in the economic climate be reflected promptly in at least a modest change in policy orientation.

Since October, Mr. Morris continued, the Manager, in following the money market strategy laid down in the directive, had provided a greater than seasonal growth in bank reserves. That

had--fortunately, he believed--given the system a little breathing room and had thus far averted the threatened financial crisis which had been dogging the Committee's heels since mid-summer. However, moving into January and February, when the seasonal forces worked toward ease in the money markets, the same money market strategy would produce a greater than seasonal contraction in bank reserves, as the staff projections indicated. He thought the point at which such a policy was appropriate had passed, unless the Committee was deliberately following a recession strategy for dealing with inflation. While it was necessary to create and maintain a margin of unused capacity, in his judgment a recession strategy would prove to be self-defeating.

Mr. Morris remarked that the Committee was concerned about budgetary control, and properly so; but he thought that concern might lead the Committee to the wrong conclusion. He would expect budgetary control to be abandoned immediately if the Congress and the Administration were to decide that the country was in a recession. The only way to maintain any sort of budgetary discipline was to avoid a recession. It was for that reason that he believed a mildly restrictive monetary policy would contribute more to the creation of an environment for fiscal sobriety than the present severely restrictive policy.

At the moment, Mr. Morris said, he would be content with the very modest change envisaged in alternative B of the directive

drafts--particularly if it was associated with a meaningful liberalization of Regulation Q.

Mr. Morris felt that a consensus was developing that the present formulation of Regulation Q was no longer a viable one and that changes had to be made. One's views on how Regulation Q should be changed would depend on one's conception of what it was expected to accomplish. In that connection, he thought the System had to make a sharp distinction between the rationale for controlling rates on ordinary savings accounts and small CD's, on the one hand, and the rationale for controlling rates on large CD's, on the other--approaching them as two quite separate problems. The rationale for holding rates payable by banks on savings deposits and small CD's so far below the rate of earnings on bank assets was to protect the flow of funds into the nonbank mortgage-lending institutions. That had two ultimate purposes: first, to maintain the viability of those institutions in a period of extraordinarily high interest rates; and second, to prevent a massive shrinkage in the flow of funds into housing.

That policy objective had had a considerable measure of success, Mr. Morris observed. There was no doubt in his mind that the flow of funds into mutual savings banks and savings and loan associations would have been substantially smaller in 1969 if the commercial banks had been free to compete for all sorts of time and savings deposits. Moreover, it had been demonstrated in 1969 that massive intermediation by the Federal

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National Mortgage Association and the Federal Home Loan Banks could help maintain a decent flow of funds into housing--although he suspected that the very success in shielding the housing industry had delayed the impact of monetary policy on the economy.

If that was the rationale for Q ceilings on savings deposits and small CD's, Mr. Morris continued, the answer was to raise the ceiling rates for both bank and nonbank intermediaries. The current pressure on the nonbank intermediaries and the consequent pressure on the mortgage market stemmed not from commercial bank competition but from the competition of market instruments. The answer must be to raise the ceilings across the board to narrow the competitive gap.

An important question in that regard, Mr. Morris noted, was how much more the nonbank intermediaries could afford to pay. The Boston Reserve Bank's research indicated that they could afford to raise their rates by at least 1/2 of 1 percentage point. The Reserve Bank had surveyed the Boston mutual savings banks and found that the average yield on their assets had risen by 57 basis points since 1966. Their average yield rose by 35 basis points in 1969 alone, and they anticipated a gain of at least 25 basis points in 1970. Unless the Boston experience was atypical, and he could find no reason why it should be, the nonbank intermediaries could afford to be somewhat more competitive with market instruments than they now were.

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Would an increase of 1/2 of 1 per cent make any difference, Mr. Morris continued, with 90-day Treasury bills offering more than 8 per cent on a bond equivalent basis? The Massachusetts experience would suggest that the answer was "yes." The Massachusetts savings banks had been allowed to raise their rates in 1969 and did so by about 1/2 of 1 percentage point, and it had made a difference. They had had a much better deposit record in the latter part of 1969 than their counterparts in other sections of the country.

Turning to the other part of the problem, Mr. Morris said the issue of ceilings on large-denomination CD's was much more complex because the System had never developed a clear rationale for their imposition. Certainly, the rationale had to be quite different from that for ceilings on ordinary savings accounts. Money invested in large CD's was money which, under current conditions, was never likely to appear on the books of savings banks or savings and loans--nor was it money which was likely to be attracted directly into the mortgage market under any conditions. He had heard it said that by restricting the access to the large CD market, the System would force banks to ration loans, particularly business loans, and the response of the economy to monetary policy would thereby be accelerated. If that was the rationale, its weakness had been a failure to take adequate account of what happened to the CD money after it left the banks.

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The 1969 experience indicated to Mr. Morris that part of that money went into the commercial paper market, financing business investment which normally would have been financed at the banks, and part of it flowed back into the banks in the form of other types of liabilities. The lawyers for the commercial banks had been kept busy during the past year inventing new types of liabilities which would not qualify as deposits. Federal Reserve lawyers, with a decent time lag but with equal ingenuity, had thus far managed to define every newly emerging type of liability as a deposit, whereupon the cycle would begin anew. In the process, the concept of a deposit had become very nebulous indeed, and the prestige of the Federal Reserve had, he believed, suffered.

Mr. Morris noted that there was an old saying in the market place: "If you're so smart, why aren't you rich?" He would like to paraphrase that by asking: "If Regulation Q on large CD's has been so effective, why has the economy responded so slowly to monetary policy?" He would feel better about the experience with ceilings on large CD's if he could find some empirical evidence to the effect that the total volume of business borrowing had been curtailed by Regulation Q--although it was clear that borrowings through commercial banks had been curtailed somewhat--or that in 1969 there had been an unusually prompt response to monetary policy. Since he could find no factual support for

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either of those propositions, he concluded that the cost-effectiveness ratio of ceilings on large CD's was extremely high, and that that fact should be recognized by the removal of ceilings on such CD's. He proposed removing the ceilings rather than raising them, because with Treasury bills selling at bond equivalent yields in excess of 8 per cent, a ceiling of 8-1/2 per cent would be required to give the banks any significant maneuvering room-- and he would much prefer to set no ceilings at all rather than to establish ceilings at such a level.

Mr. Morris remarked that both of his proposed changes-- the 1/2 of 1 percentage point across-the-board increase for savings deposits and small CD's and the elimination of ceilings on large CD's--were capable of being explained to the market solely in terms of the changes which had occurred during the past year. It was usually the better part of wisdom, he felt, to recognize a failure rather than to temporize with it, and he thought the time had come to recognize the failure of ceilings on large CD's.

Mr. Coldwell reported that following several months of strong advances, industrial production in Texas appeared to be leveling off as durable goods manufacturing and mining output had shown recent declines. Construction contracts were also headed downward but employment continued to rise. Over all, the District economy still seemed to be riding a crest. The momentum of upturn

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had faded and--although for the moment no real downward pressures were evident--there was a growing apprehension that declines were not far off.

District agricultural activity was almost at a standstill, Mr. Coldwell said, as a result of both normal seasonal and weather factors. The 1969 results were generally unfavorable in all major crops, with cotton output down 14 per cent from 1968, grain sorghum production off 8 per cent, and rice down 20 per cent. Livestock activity showed strong gains in 1969 but the advance in feed-lot operations was now tapering off. The supply of beef cattle appeared to be in fairly good balance with demand. Prices received by Texas farmers and ranchers continued to advance and, as of December 15, they were 11 per cent above the year earlier level.

Recent District banking developments included strong seasonal pressures and end-of-year statement adjustments, Mr. Coldwell continued. Heavy business loan demand and some increase in time deposits were highlights of the past few weeks. However, there were sizable transfers of loans from subsidiaries to banks, apparently for purposes of establishing higher loan totals as a base for bad debt reserves.

Mr. Coldwell added that borrowings from the discount window of the Dallas Reserve Bank had slowed considerably, although--except for year-end dates--net Federal funds purchases

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had continued quite strong. In early 1970 a large unwinding of year-end positions, coupled with an acceleration of savings and time deposit withdrawals, had already occurred. However, recent contacts with savings and loan associations indicated year-end losses well within the range of expectations of 2 to 4 per cent and a surprising number of new accounts opened. District commercial bankers were very apprehensive about deposit losses and believed they had to have additional help to tide them over. Loan demands were strong and pressures for bank investment in local municipal securities at less than market rates had become intense.

Mr. Coldwell's interpretation of the trends and recent changes in national economic statistics indicated a further slowing of the production and consumption of consumer goods, a slight lessening of the capital goods pressures, and a decline in Government spending; but continued rapid price and wage increases, persistent business expectations of further rapid inflation, and only selective imbalances in inventory positions. Possibilities for the near-term future appeared to encompass continuation of those trends, with perhaps a further slowing of industrial production and eventual increases in unemployment.

Financially, the Desk's operations appeared to Mr. Coldwell to have been almost overwhelmed by end-of-year adjustments, seasonal pressures on rates, and some special influences. A tone of slightly less restraint had crept into the markets and into

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banking statistics, even though most large banks seemed to consider their positions still very tight. Some bankers now had greater concern for improved liquidity than for loan accommodation of customers.

Perhaps overshadowing the present positions, Mr. Coldwell said, were the very heavy suppressed credit demands of State and local governments and others. Any easing in credit supplies would probably be subject to intense competition between the suppressed demands of borrowers and the liquidity desires of banks.

Mr. Coldwell commented that bank positions had deteriorated sharply with the loss of deposits, and attitudes were hardening that an unfair degree of restraint was being placed on banks compared to other lenders. Those attitudes were especially bitter toward Regulation Q ceilings and the regulatory restraints on other devices constructed by banks to alleviate the pressure. He had some considerable sympathy for banks' problems in that regard, but he had a greater concern that credit restraint be continued, even if there were inequities and differential impacts. The ultimate objective of stabilization was, in his opinion, too important to give up or even substantially alter. He was prepared, however, to see some changes in the methods of achieving restraint and, in fact, he was hopeful that such changes might make a more efficient and effective contribution to stabilization. He differentiated between those measures necessary in today's environment

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and the most desirable long-run regulatory position. Thus, he was willing to create temporary regulatory restraints but simultaneously attempt to accommodate a better flow of funds to the banking system. He had previously recommended at meetings of the Committee that Regulation Q ceilings on large-denomination negotiable CD's be raised, with some offset by regulatory restraint on bank issuance of commercial paper. He continued to believe that that compromise was desirable, but he would modify it to minimize the chances of an intense rate war or unequal bank competition for funds.

Mr. Coldwell's recommendation was that Regulation Q ceilings be advanced to 8 per cent on all negotiable CD's of \$100,000 and above. But he would limit bank purchases of large-denomination CD's to a percentage of total deposits or a relationship to bank holdings of Government and municipal securities. Concurrently, he would place regulatory restraints of Regulations D and Q upon commercial paper issues by banks and their holding company affiliates and all related nonbank affiliates or subsidiaries. Such changes would be labeled temporary and subject to reversal or modification when credit demands moderated and inflationary pressures abated. He recognized the problem of inequities between classes of savers as the ceiling for negotiable CD's was increased, and he believed there could be some advance in rates for the small savers, though the margin of leeway was probably very small--perhaps only 1 to 2 percentage points. On timing, he would prefer a coincident move on both CD's

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and commercial paper on February 26, thus deferring action for the present.

With regard to policy, it was Mr. Coldwell's opinion that the Committee was beginning to see some results from its restraining efforts of 1969. The crucial questions of today were the timing and degree of relaxation the Committee could permit and the methods of achieving it. He was very concerned that the Committee not give up its hard-won progress, but he did not want to pay a greater price in economic retrenchment than was necessary to achieve success. The timing decision was probably narrow, but he would prefer that the Committee defer any easing at least for the coming period and then relax only on the basis of observed results and only in marginal credit accommodation. The seasonal reflows provided an opportunity for moderation of the intensity of restraint, but he would not accept that opportunity at the moment. It was difficult to establish an open market policy in the absence of knowledge of what Regulation Q action might be taken, but if ceiling rates were raised he believed the Committee would need some time for careful appraisal of the impact of the action. Only then could it judge the need for additional easing of reserve positions through open market operations.

For the coming weeks, Mr. Coldwell said, the Committee had to give consideration to the Treasury refunding. However,

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in view of the lessening fiscal restraint and the persistent inflationary expectations of business, he would permit only a very minor shading away from the taut money market conditions of early December. In his opinion the monetary aggregates should reflect only minor seasonally adjusted growth rates. His target for the first quarter of 1970 would be a 1 per cent rate of growth. As a target for open market policy, the quarterly averages were to him the closest goals toward which the Committee could strive. He noted that, until the estimates of such aggregates improved sharply, he would resist a shift to specification of aggregate targets in the directive and, in fact, he believed that their use in the proviso clause should be severely curtailed. The Committee had seen continuous examples of the problems of estimating the monthly monetary aggregates. He did not believe it should permit a proviso modification of policy based upon such tentative estimates.

Mr. Coldwell said he would accept alternative A of the draft directives.

Mr. Swan reported that a general leveling off of growth seemed to be occurring in the Twelfth District, as well as in the country as a whole. The pattern of outflow of funds from District financial institutions over the year end and through January 10 had been about the same as that described for the nation by Mr. Keir. The withdrawals from savings and loan associations had been substantial and those from commercial banks somewhat less so;

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and both types of institutions were relieved that the outflows were not as bad as had been feared. However, there probably would be further outflows during the rest of January, particularly since interest was now payable up to the date of withdrawal at most institutions.

Turning to policy, Mr. Swan said that, given the slowing of the economy that had already occurred and that anticipated in the projections, growth in the monetary aggregates--at a very moderate rate--would be needed in the months ahead. While some relief of pressures in the money market could be expected on seasonal grounds in the current period, he would not like to see the Committee rely wholly on that kind of development. Moreover, the even keel considerations associated with the forthcoming Treasury refunding would limit the Committee's freedom of action at its next meeting. Also, while he shared some of the concern already expressed about the outlook for fiscal policy, he thought there would not be much point in deferring action until after the Budget Message was delivered. That was because the actual stance of fiscal policy would be determined not by the Message but by Congress's disposition of the Administration's proposals--which would not be known for a considerable time.

Consequently, Mr. Swan remarked, he would favor adoption of alternative C for the directive today. The growth rates in the monetary aggregates projected under that alternative were modest indeed, and not in any way out of line with the projections

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for the real economy. It seemed to him that in any case it would be highly desirable to consider growth rates in the monetary aggregates for a quarter ahead rather than for a month, and he hoped that at coming meetings the Committee would regularly consider expected developments over the succeeding three months. He agreed that such a procedure would not commit the Committee to any particular policy course for the future.

In his opinion, Mr. Swan continued, alternative C did not represent as radical a change from the traditional directive as had been suggested in the preceding discussion. The primary instruction was still cast in terms of money market conditions. The reference to monetary aggregates could be viewed as involving merely a somewhat more specific statement of an instruction that was implied by the proviso clause of the customary type of directive. The fact that there might be problems in measuring the aggregates did not appear to be a good reason for leaving vague the reference to them in the directive.

Mr. Swan then observed that in alternative A of the directive drafts the staff had proposed language describing one of the Committee's broad policy goals as that of "laying the base for" sustainable economic growth. If the Committee adopted alternative A he would prefer to retain the language used at the corresponding point in other recent directives, describing the objective as that of "encouraging" sustainable growth.

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With respect to Regulation Q, Mr. Swan said that like some others he had had difficulty in arriving at a specific recommendation. At the moment the kind of modest shift in open market operations that he favored was probably more important than a change in the ceiling rates; despite all of the continuing problems posed by Regulation Q, now that the year-end interest crediting period had passed the matter had become less pressing.

In general, Mr. Swan continued, he thought the present structure of ceiling rates produced a serious problem of inequity in the case of small-denomination CD's. He would like to see a small increase in the ceilings applicable to those deposits, perhaps related to the period for which the funds were committed. With respect to large-denomination CD's, he felt that the appropriate long-run goal would be to raise the ceilings to levels that would be well in line with market rates. However, he would be concerned about the possible market reaction to such a step--or to the complete removal of the ceilings--at this time. Accordingly, he would recommend delaying any action on large CD's until February 26, when some regulatory action with respect to bank-related commercial paper might be made effective.

Mr. Galusha commented that to judge from the information contained in the latest green book, the pace of economic advance had slowed and likely would slow further in coming months. It appeared that the staff projections of last October were being

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borne out, if not in every detail. Happily, for them and for the Committee, Mr. Partee and his associates were being proved right.

It seemed to Mr. Galusha that there had been some slight progress in the fight against inflation and that the time had come for a modest change in Committee policy. The temptation, made stronger by Congressional irresponsibility and gratuitous advice from outside, was to hold policy unchanged. But doing so for many more months would, in his judgment, be too risky.

Mr. Galusha said the Committee had to keep in mind that the Board staff's October projections were based on the assumption of a change in Committee policy. If he remembered correctly, the staff had assumed that total reserves would increase at a 2 per cent annual rate over the first half of 1970 and at a 4 per cent annual rate over the second half. Over the second half of 1969, however, the rate had been a minus 2 per cent or thereabouts. Thus, an increase in the rate of growth of total reserves, contrived by the Committee, seemed appropriate.

Accordingly, Mr. Galusha continued, he favored alternative B of the draft directives and the target values associated with that alternative in the blue book.^{1/} From what was said

^{1/} The blue book passage referred to by Mr. Galusha read as follows: "Slightly less firm money market conditions might encompass a Federal funds rate averaging consistently below 9 per cent, perhaps in an 8-1/2 - 9 per cent range, net borrowed reserves averaging around \$800 million, and member bank borrowing generally a little below \$1 billion. The 3-month bill rate under these conditions may drop to or somewhat below 7-1/2 per cent, although dealer financing costs are likely to remain relatively high and still be a constraint on dealers' willingness to add to positions."

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later in the blue book in connection with alternative C, it appeared that the alternative B target values were consistent with the development, although not immediately, of a reasonable rate of growth of reserves.

In Mr. Galusha's judgment, the adoption of alternative C of the draft directives would involve too great a change in Committee policy. Also, he was not sure that, without discussion and before having heard from the Maisel directive committee, the Open Market Committee should alter fundamentally its modus operandi.

With respect to Regulation Q, Mr. Galusha observed that he had not changed his mind about what should be done with the ceiling rates. He believed the Board would do well to increase CD ceiling rates--and not just a little, which would make little if any sense--but above prevailing short-term market rates. The Board might also, perhaps in concert with the Federal Deposit Insurance Corporation and Federal Home Loan Bank Board, increase ceiling rates for other time and savings deposits. Doing so would help some, if not greatly; and savings and loans could now, it seemed to him, afford to pay somewhat higher rates to shareholders than they could, say, 12 months ago.

Mr. Galusha remarked that an increase in CD ceiling rates by the System might be interpreted as throwing in the towel. He was willing, however, to run that risk, partly because he

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feared the consequences of a continuing run-off of CD's. And he did dislike direct controls, even as administered by a benevolent Federal Reserve System.

Mr. Galusha noted that he had intended at this point to comment about the importance of the System's continually measuring its tools against their accomplishments in use. However, Mr. Morris had said it so well that he would content himself with a simple amen.

In concluding, Mr. Galusha said that if CD ceiling rates were increased he would like to hear again from Mr. Partee and his associates; and the sooner the better. He was far from certain, but he thought an increase in CD ceiling rates could require a change in the Committee's monetary target values. A 2 per cent annual rate of growth for total reserves was presently consistent with the green book projections but it might no longer be, once CD ceiling rates had been increased.

Mr. Scanlon said he would summarize the comments he had prepared regarding economic conditions in the Seventh District and submit the full statement for inclusion in the record. He then summarized the following statement:

Economic restraints clearly are taking hold in the Seventh District. Expectations of businessmen are increasingly bearish, construction contracts are down sharply, total factory output is drifting down, consumer purchases continue sluggish, and some easing is apparent in the labor market. These trends are generally consistent with evidence provided by national economic aggregates and with the important role of consumer durables in the District. The continued strength in producer durables, of course, provides a moderating influence.

Prices of goods and services continue a strong rise.

Unemployment compensation claims rose further in December. New claims were up about 20 per cent from a year earlier in the Seventh District States, but still were not high relative to earlier years of "full employment." Secondary layoffs caused by the General Electric strike and other strikes were partly responsible. Despite some slight easing in the job market, initial demands by unions in labor-management negotiations are larger than in any recent year.

Price increases averaging 3 to 5 per cent (but ranging as high as 10 per cent) continue to be reported for a wide variety of goods and services.

Deliveries of domestically-produced autos (including those from Canadian plants) dropped sharply in December to about the same level as December 1967--when strikes limited supplies--and were lower than in any December since 1962. Scheduled production of automobiles for January (reduced at least twice in recent weeks) is on a daily rate basis 20 per cent below last year and the lowest since January 1962.

Demand for machinery and equipment continues to show strength, despite some weak spots such as machine tools. Backlogs of capital spending appropriations are larger than ever, especially for District utilities. We see no reason to doubt the Commerce-SEC projection of a 10 per cent rise in plant and equipment expenditures in 1970 unless the economic environment deteriorates more than is projected in the green book.

Advance payments to farmers under the Government's feed grain program will not be made this spring. This probably will reduce farm spending temporarily, and may increase the demand for farm loans. Farmers in the District received about \$125 million in advance payments last year--about one-third of the national total.

The banking figures give little evidence that credit demand may be slackening, but these data are difficult to interpret at this time, given the distortions related to year-end window dressing by both banks and their customers and the unusually large temporary needs stemming from low corporate liquidity. However, total loans at the smaller member banks, consumer loans at the weekly reporters, and business loans at the smaller weekly reporters all increased less in December 1969 than a year earlier.

The money market banks remain in very deep basic deficit positions, covered mostly by purchases of Federal

funds. With one exception, just prior to the year end, these banks have not borrowed at the window. In fact, borrowing at the window is currently at a very low level, and funds obtained through nondeposit sources have declined. There has been no significant increase in the District in commercial paper sold through holding companies. Loans sold to affiliates declined almost \$300 million in December, and Euro-dollar borrowings are down more than \$200 million.

The slowing in production and employment projected earlier is being realized and, in view of the lag in the effects of monetary policy on economic activity, there is a strong probability that the recent "cooling" trend will continue for some months. It seems, therefore, that we should undertake a policy designed to achieve slow growth in money and bank credit. Further delay in adopting such a policy would probably bring a greater slowing in business activity than is projected by the Board's staff in the green book. I accept the staff's projections for the next 6 months as desirable economic goals. It is my understanding that these projections assume some growth in the money stock and bank credit, which should be achieved.

Mr. Scanlon then said that, as the Manager had indicated, the money market might be experiencing a seasonal turn to an easier trend. He would like to preserve that and not offset it. The policy outlined by Mr. Partee had his support, at least to the degree that he would like to see some modest growth in the monetary aggregates. As a matter of fact, he thought the record would show that that had been the desire of a majority of the Committee for several months.

Mr. Scanlon remarked that he favored the words in alternative C, but it would represent a departure from customary practice before the Maisel committee had completed its report; and in any case he would not want to adopt it without hearing the Manager's

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interpretation, particularly in light of the forthcoming Treasury financing. However, on first reading at least, it did not seem to him to involve as great a change in procedure as some had suggested.

Mr. Scanlon expressed the view that from a purely economic standpoint Regulation Q had no justification. He recognized, however, that the System was not starting with a clean slate. He favored upward adjustments in the ceilings, with a large increase in the maximum rates on large-denomination CD's. He would just as soon see the first move toward providing for more growth in the monetary aggregates center around a Regulation Q change--giving the banks access to the markets for funds at current rate levels. He would make the change concurrent with regulatory action on commercial paper. In any case, he would like to see some modest growth in the monetary aggregates.

Mr. Clay remarked that real economic activity continued to show increasing response to public economic policy restraint. While there was substantial variation among economic segments, the slowdown had taken place on a broad front. However, the record on prices was not encouraging, even when allowance was made for the expected lag in price response. Price inflation continued with considerable momentum, and it was difficult to know whether there had been any significant dampening of inflationary expectations. Yet there was evidence that weaker markets

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were having some impact on actual selling prices of automobiles and a considerable range of consumer durable goods.

Mr. Clay said that wage negotiations and settlements, with their impact upon the pricing of goods and services, constituted a serious threat to the success of the inflation battle in the year ahead. Another serious handicap was the probable role of fiscal policy. Placing less reliance on monetary policy through a balanced monetary-fiscal approach would not only be more effective, but it would lessen some of the financial distortions and risks associated with the heavy reliance on monetary policy.

At present, Mr. Clay continued, it would appear to be in order to make some modification in the interest rate ceilings on time and savings deposits under Regulation Q, with a view to reducing the flow of funds away from commercial banks--as well as nonbank thrift institutions, if similar action were taken with respect to them. The case for raising interest rate ceilings on larger-denomination CD's was stronger than that for consumer deposits. In view of the inroads now being made on consumer deposits, however, it would seem better to take the action with respect to both categories. Considering the existing degree of stringency in those financial institutions, the growing exodus of funds for investment in other forms constituted a redirection in the flow of funds involving some potential risks, without serving constructively in the battle against inflation.

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Mr. Clay noted that there were several uncertainties of some importance associated with such action, namely, the effect on the flow of funds, the response in market interest rates, and the public's interpretation of the meaning of such a step. As the action might still leave ceiling rates below open market rates, the principal effect on the flow of funds might be in slowing the outflow rather than in attracting new deposits. The response in market interest rates probably would be quite marked at first, but subsequent reaction would depend upon the market's interpretation of its monetary policy significance. That would be conditioned by the System's over-all monetary policy posture, as well as by the explanation given in the announcement of the changes in Regulation Q.

Mr. Clay thought the System needed to continue a policy of vigorous monetary restraint. In fact, success in the battle against price inflation probably would require little or no over-all real economic growth over a full year or so. Accordingly, if Regulation Q was not relaxed, it would be preferable to adopt alternative A of the draft economic policy directive today. The primary purpose of raising Regulation Q ceilings on interest rates should be to affect the distributive flow of funds. Under those circumstances, the credit proxy and other financial aggregates presumably would shift to a different order of magnitude. Thus, the financial variables would require a new set of specifications for the maintenance of a policy of vigorous restraint.

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Mr. Clay remarked that some comments about this week's Treasury bill auction might be of interest. As the Committee knew, there had been a record volume of non-competitive bids. Ten per cent of that non-competitive bid volume for the whole country had been handled by the four offices of the Kansas City Reserve Bank. That was twice the volume of a month ago. It was too soon to know much about what had happened to Tenth District commercial banks and savings and loan associations since the turn of the year. It was known that most of the non-competitive bids for Treasury bills just received were from individuals--and bids from individuals would have been of little importance a few months ago. While commercial banks had submitted many of those orders this week, they had bid very little for their own account. Most checks endorsed in payment by the very large number of walk-in buyers of Treasury bills at the Kansas City Reserve Bank in the last two weeks apparently had represented withdrawals from savings and loan associations.

Mr. Heflin remarked that if the latest statistics were anywhere near the mark, the economy's advance had slowed significantly; and he believed the Committee had to give serious consideration to the possibility that it might slow more than was desirable. But with business capital outlays slated to rise substantially in this half-year and in view of the prospective fiscal stimulus in the months ahead, he thought the Committee

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faced risks in the other direction as well. Policy, it seemed to him, had to strike a balance between those two sets of risks.

He was not sure today just how those risks should be evaluated, Mr. Heflin observed. He was impressed with the extent of the slowing indicated in the fourth-quarter statistics, but he thought one could make too much of that. After all, the Committee had been doing its best to achieve just such a slowdown. Moreover, it might be worth noting that, while the leading indicators now were tilted slightly downward, they had shown no great weakness over the past few months. Also, financial markets did not appear to have been greatly impressed with the evidence of a cooling economy. Despite the recent rally in the bond market, it seemed to him that market psychology remained dominated by the heavy corporate and municipal calendars and by the possibility that the Federal budget might soon revert to deficit. In any case, it was clear that credit demands remained heavy. Some part of that demand was no doubt associated with efforts to restore liquidity. But the possibility should not be ruled out that much of it was related to current and near-term spending plans. With businessmen and State and local governments prepared to take large amounts of loan funds and with basic housing demand remaining strong, he would feel fairly confident that there was a relatively high floor under any business slowdown that might develop. For the same reason, he would be concerned that too

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pronounced a relaxing move at this juncture might quickly be translated into a step-up in spending and a resurgence of inflationary psychology.

Yet, Mr. Heflin continued, given the latest evidence of slowing the degree of restraint the Committee had maintained in recent weeks might no longer be appropriate. That posture had been directed at forcing a significant slowdown in the rate of spending growth. If the economy had slowed as much as was now indicated, that objective had been achieved. The Committee's problem now became one of maintaining the more moderate rate of spending growth, with little deviation on either the upside or the downside. His biggest concern in that connection was the current budgetary prospect, although he found some encouragement in the Administration's apparent determination to hold the budget under reasonably close control. In any event, it now seemed likely that relatively little of the stimulus arising from that source would be realized in the first half.

On balance, Mr. Heflin said, he came out with the view that some relaxation of the present tight posture might be necessary if too much slowing was to be avoided in the months ahead. He would not favor any major easing move at this time, but he believed the time had come to make a probing move in that direction. In particular, he believed the System should be resisting any declines in the credit proxy.

As for Regulation Q, the big question in Mr. Heflin's mind was whether a change in rate ceilings could be used as a basis for such a probing move. In principle, and on purely regulatory grounds, he favored the elimination of rate ceilings on large-denomination CD's and the simultaneous extension of Regulation D to cover most of the nondeposit sources of funds resorted to in recent months by banks. As a policy matter, however, the present would appear an inappropriate time to take such action. With the market keeping a weather eye cocked for any sign of a change in policy, he would be afraid that complete elimination of ceilings on large CD's would be interpreted as a major easing move. On the other hand, that risk might be minimized if, as part of a package that would have the effect of increasing required reserves by a small amount, the schedule of ceilings on large CD's was raised to levels that would allow banks some limited capacity to compete for money market funds. He believed there was a good chance that a package move along those lines would be interpreted as only a slight relaxation, and he would not be opposed to leading a probing move in that manner rather than through exclusive use of open market operations. However, he would confine any change in Q to CD's in the \$100,000-and-over class and, in particular, except after consultation with the other regulatory agencies, he would not change the ceilings on pass-book savings or consumer-type CD's.

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Mr. Mitchell said it was now evident, after three to five months of moderation in consumption, production, and employment, that the economy was on a downtrend. The staff's GNP projections had been on target for the fourth quarter, but he suspected that those for the first half of 1970--as well as the second half--were too high; in any case, they appeared too high to be consistent with the Committee's goal of defeating inflation. In any event, as a consequence of policy actions already taken, further declines could be expected in housing, business investment in inventories and in plant and equipment, and spending by State and local governments. He thought the staff's projection of a squeeze on profits was probably accurate, but he doubted that businesses had as yet become aware of the likely dimensions of the squeeze. As they did so there should be some desirable abatement in the strength of inflationary expectations.

Against that background, Mr. Mitchell said, it seemed appropriate to him to make a very modest change in the direction of policy today. He had absolutely no difficulty with alternative C of the directive drafts; he thought it was meaningful and that it accurately communicated to the Manager the policy course that he (Mr. Mitchell) would favor. To him it meant an annual rate of growth in the money supply of 2 to 3 per cent during the first quarter; and it implied that if the target for January was missed an effort would be made to compensate in the

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subsequent period. He thought Mr. Keir's comments on the differences between alternatives B and C added up to a persuasive case for the latter. Alternative C had another advantage over B; the latter included a one-way proviso clause, whereas C was symmetrical with respect to excesses and shortfalls of the aggregates relative to the projections. Since an upsurge in the aggregates at this point might well be fatal to the Committee's objectives, it was important to instruct the Manager to respond to significant deviations in either direction; and it was particularly important to do so now, in light of the possibility of a change in Regulation Q.

Turning specifically to the issue of Regulation Q, Mr. Mitchell remarked that he agreed with Mr. Morris' analysis but not with his conclusions. He (Mr. Mitchell) believed that if the ceilings on large-denomination CD's were removed today banks would immediately increase their willingness to make commitments. Mr. Morris was probably right in implying that that would not result in a significant net expansion in the aggregate volume of lending to business. But since that outcome was not assured, he (Mr. Mitchell) would not want to take the risks involved in completely removing the ceilings on large-denomination CD's.

Mr. Mitchell said that the Regulation Q problem, while basically a structural issue, did have some secondary policy implications. Total credit flows were more significant than flows through banks. However, because data on the former were available

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only after a relatively long lag, attention tended to focus on the banking statistics. In his judgment the appropriate annual rate of growth for time and savings deposits now was in the range of 3 to 6 per cent. A large increase in interest rate ceilings could result in a considerably faster growth and that, in turn, could produce a significant change in attitudes toward commitments. Accordingly, if a change in Regulation Q ceilings resulted in a large increase in bank credit flows the Board probably would have to backtrack. That consideration led him to the belief that any change in the ceilings should be small.

Mr. Daane said his feelings on policy today were mixed, for reasons not unrelated to the historical significance of this meeting. There was also a basic problem in formulating views on open market policy that stemmed from the difficulty of abstracting from the question of possible action on Regulation Q. As had been noted, action in that area would seem to call for a reformulation of the blue book projections.

In general, Mr. Daane observed, he concurred in Mr. Hersey's view that it would be desirable to lighten a little the existing pressures on bank liquidity. However, he thought any such move should be small and experimental. Therefore, he favored alternative A for the directive, with the amendment suggested by Mr. Swan. He would also add some reference to possible regulatory action, as had been done on other recent

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occasions when it had appeared likely that regulatory action would be taken. Such a reference could be taken to imply the expectation of some modest growth in the aggregates.

Mr. Daane remarked that he preferred to stay within the framework of alternative A because he was worried about the risk of reinforcing inflationary expectations. Such expectations were likely to be stimulated further if a dramatic move, involving both increases in interest rate ceilings and an easing of open market policy, were taken by the System now.

As to Regulation Q itself, Mr. Daane continued, like Mr. Mitchell he found much to commend in Mr. Morris' thoughtful analysis. But, again like Mr. Mitchell, he did not agree with the conclusion that Q ceilings should be removed entirely at this time. However, he thought the ceilings should be raised enough to make the change meaningful. If such action were to be taken soon, the Committee could adopt alternative A and still encourage some modest rate of growth in the aggregates.

Mr. Daane observed that if it were necessary to abstract completely from possible changes in Regulation Q--and also from possible moves in the commercial paper area, which, in his view, should accompany any Q change--he would favor directive language closer to alternative B than to C. He would stress, however, that the change in policy he would seek under B would be only slight, and of a probing variety.

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Mr. Maisel said he was happy to see that the blue book offered the Committee three choices at this meeting. Since some members had commented on the subject, he might note that he did not consider the proposed alternative C to be too closely related to the work of the directive committee he was chairing, although some of the same ideas might prove to be involved in both. As had been pointed out, alternative C followed the pattern of the Committee's present directive. The primary changes were in the form of the proviso instruction, and in the general effort to achieve greater clarity than in the past as to the Committee's objectives.

Mr. Maisel remarked that it was important today for the Committee to express itself clearly as to the type of monetary policy it wanted to prevail until the next meeting. It seemed to him that the choice of policy was much clearer under alternative C than under alternatives A and B. That was why he supported C. That alternative also seemed to solve the problems to which Messrs. Daane and Clay had called attention. Alternative C called for a specific monetary policy, namely, one of monetary restraint with a moderate and orderly expansion in the monetary and banking aggregates.

Mr. Maisel's concern with alternatives A and B was that neither gave any clear indication of what policy the Committee desired or believed would prevail in the coming period. They

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were written in terms of slightly more or less firm money market conditions. While there were staff guesses as to what that might mean for the immediate period, no one could say whether or not adoption of either of those alternatives would result in a policy of higher or lower interest rates, or more or less expansion of money. There was no instruction to the Manager concerning such moves and only a weak proviso, instructing the Manager to be concerned only--at one extreme--if bank credit failed to decline; or--at the other--if it declined drastically, by more than 6 or 7 per cent.

The reason for that uncertainty was evident, Mr. Maisel continued. Constant money market conditions could allow the type of sharp fluctuations in rates and aggregates that had taken place in the past eight months. In the same way, even larger movements could occur in the next month or two, depending upon the accuracy of the staff economic projections, any changes in actual liquidity, and, more significantly, any changes in expectations as a result of possible action in the sphere of Regulation Q. Thus, alternative A or B might or might not result in a major shift in policy. No one knew and even guesses were difficult. Certainly there was very little information before the Committee as to anyone's view.

Under those circumstances, Mr. Maisel said, defining policy in terms of money market conditions was much like a game

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of Russian roulette. The Committee was pulling the trigger and some monetary policy would follow. Unfortunately, the Committee had no way of judging what that policy would be. He hoped that at this time the Committee could avoid the type of situation which had arisen at turning points in the past--when, by specifying money market conditions and no additional, more viable indicator, it had allowed very large and undesirable swings in bank credit and other monetary aggregates as well as in short-term and long-term interest rates.

That, Mr. Maisel thought, was the difference between alternatives B and C. While the staff had judged--excluding from their consideration the probability of some change in Regulation Q--that the two would not differ in the current period, alternative B locked in particular money market conditions together with whatever policy resulted, while alternative C attempted to indicate the type of policy the Committee would like to achieve.

While Mr. Maisel was not certain that if he had his choice he would pick the particular policy called for under alternative C, he did feel that the important consideration at this time was to pick a specific--as opposed to an uncertain--policy, recognizing that it could be changed at the time of the next meeting. Therefore, he would support alternative C.

Mr. Brimmer said he might note first that this was the time of the year when fiscal policy was being formulated

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and when both fiscal and monetary policy would be under intense discussion. The Administration's Economic Report was scheduled to be submitted to Congress on February 2, and the incoming Chairman of the Board presumably would be called upon shortly thereafter by the Joint Economic Committee to make an assessment of recent and prospective monetary policy. Dr. Burns probably would find it difficult to formulate such testimony unless there had been some specific indication of the attitude of the System with respect to the appropriate direction of policy. In his judgment, the System's attitude could be communicated most clearly by Board action on Regulation Q. In sum, he would favor having the Board, rather than the Committee, take the lead in indicating the direction in which the System thought monetary policy should go.

In his judgment, Mr. Brimmer continued, an early change in Regulation Q ceilings on large- and small-denomination CD's and on savings deposits--if modest in extent and clearly explained--would put the System in the kind of position it could maintain for a long period. He did not believe the time had come for any significant relaxation of open market policy, and he thought it was important to avoid giving the impression of such a relaxation.

To illustrate the kind of open market policy he had in mind, and drawing on the Board's experience in classifying the competitive effects of proposed bank mergers, Mr. Brimmer had worked out a scale ranging from "extreme" restraint through "substantial" and "considerable" to "slight" restraint; and then to

"slight" ease, and on to "considerable," "substantial," and "extreme" ease. In his view, at this time the Committee should not back off very far from extreme restraint--only to what might be considered to be the boundary between extreme and substantial restraint. For this purpose, he would favor a directive with instructions intermediate to those contained in alternatives A and B of the staff's drafts. Specifically, he suggested calling for operations "with a view to achieving a slightly lessened degree of restraint in money market conditions." He would also favor using a two-way proviso clause, such as that in alternative A, rather than the one-way clause shown in alternative B.

In a concluding comment Mr. Brimmer said he had found Mr. Morris' analysis of Regulation Q to be thoughtful. He agreed that it would be desirable at some point to remove the ceilings from large-denomination CD's, but did not think the present was an appropriate time to take such a step.

At this point the meeting recessed. It was reconvened at 2:20 p.m. with the same attendance as at the morning session.

Chairman Martin noted that Mr. Brimmer had some further comments to make supplementing his earlier remarks.

Mr. Brimmer observed that in proposing directive language between that of alternatives A and B he had not specified the money market conditions and growth rates in the monetary aggregates that could be associated with such an intermediate instruction. However, during the lunch hour the staff had made rough

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estimates of such specifications on the same assumption as employed in the blue book for alternatives A and B--namely, that there would be no Regulation Q changes. The estimates called for a Federal funds rate averaging 8-3/4 to 9 per cent; net borrowed reserves a little below \$1 billion; borrowings a little above \$1 billion; and a 3-month bill rate in a range of 7-1/2 to 7-3/4 per cent. The adjusted bank credit proxy was projected to decline at an annual rate of 1 to 4 per cent in January and to decline at a 3 to 6 per cent rate in February. The money supply was projected to remain about unchanged in January and to rise at a 5 to 6 per cent rate in February.

Mr. Brimmer then noted that he had one further change to suggest in the directive language. Following the instruction to take account of "the forthcoming Treasury refunding," the phrase might be added, "and possible regulatory actions relating to interest rate ceilings."

Mr. Sherrill said he thought that substantial progress had been made in the battle against inflation, but that there was still a considerable distance to go. He believed the inflection point had been passed on the rising curve of prices and an effort was needed now to consolidate the gains that had been made.

Mr. Sherrill remarked that there were risks both in continuing the existing degree of restraint and in relaxing somewhat. On balance, he thought the former risk was greater, partly because

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of the length of time the present policy had been in effect. While he still advocated a restrictive policy stance, he thought it would be desirable to relax the degree of restraint slightly.

Mr. Sherrill suggested that if it were not for the increasing level of plant and equipment expenditures planned by business, the existing degree of restraint would be considered by most members as risking much more weakness in the economy than anyone would want to see. In other words, those business spending plans constituted much of the justification for the existing policy. In his judgment, however, those plans were more vulnerable than might appear on the surface because of their close relationship with corporate profits. If, as seemed probable, corporate profits should decline, there might well be drastic downward revisions in capital spending plans for both the short- and long-term period ahead.

For that reason, Mr. Sherrill continued, he thought the Committee should reposition its policy for a longer-run holding action. He favored a course somewhere between those called for by alternatives B and C of the directive drafts. In general, if the pattern of change in the aggregates appeared to be weaker than those for the first quarter called for under alternative C, he would want to seek money market conditions near the easier ends of the ranges specified for the coming policy period under both B and C. Thus, if it appeared likely that first-quarter growth in the money supply would be zero and that in

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bank credit zero or 1 per cent, the target level of net borrowed reserves should be moved down to \$700 million.

Mr. Hickman commented that real economic growth apparently had come to a halt in the last quarter of 1969. The continued decline in industrial production, prolonged sluggishness in retail sales, and near-zero growth in nonagricultural employment were typical of the initial phases of business contractions. The slowdown would almost certainly continue in the months ahead, since the only elements of potential strength in the economy were consumer expenditures for nondurables and business expenditures for plant and equipment. If capital expenditures fell short of the Commerce-SEC projections--and he agreed with Mr. Sherrill that they probably would--the business contraction could be quite severe.

Economic activity in the Fourth District was clearly in a contractionary phase, Mr. Hickman continued. The insured unemployment rate for the District had increased in November and it rose again in December. District manufacturing activity and Ohio labor income had declined in October, and the decline accelerated in November. The Cleveland Reserve Bank's latest survey of Fourth District manufacturers showed deterioration in new orders, inventories, and employment in December, and further declines were anticipated for January. Moreover, prices were still rising and the respondents expected them to rise further in the future. Steel output in the area declined

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more than seasonally in December, and expectations were for further reductions in steel and auto production during the first quarter of 1970.

In view of the deteriorating situation, Mr. Hickman recommended again--more urgently than before--that the Committee shift today to a less restrictive monetary policy. He proposed a moderate policy adjustment now and favored a directive cast in terms of reserve, monetary, and banking aggregates. He was not quite satisfied with the wording of alternative C of the draft directives in its present form, with its implications of a priority for money market conditions over the money and credit aggregates. Nevertheless, he supported the general thrust of alternative C.

Mr. Hickman said his view on Regulation Q ceilings remained the same as before. In the long run, they should be eliminated, or at least modified to such an extent that they would not cause the wide swings in intermediation and disintermediation that had occurred in the past several years. Over the near term, however, he felt that the System had to maintain and strengthen the regulations now in force, since to do otherwise would enlarge the flow of loanable funds through the banking system. Any change now would be interpreted as an abrupt shift towards ease, and would probably cause increased turbulence in the capital markets and greater stresses in capital flows among financial intermediaries.

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It seemed to Mr. Hickman that the Board should move promptly to place commercial paper under Regulations Q and D, and should issue a statement that would eliminate issuance of low-denomination capital notes where the issuer made a continuing secondary market in such notes. Other subterfuges of that nature should also be eliminated before they became major nondeposit sources of funds.

By way of summary, Mr. Hickman said the System should move promptly towards moderately less restraint implemented by open market operations, but should not make an overt move through changes in Regulation Q.

Mr. Bopp reported that the impact of monetary restraint on financial institutions in the Philadelphia area continued to be severe. Philadelphia's latest contribution to financial innovation--the 7-1/4 per cent capital notes in small denominations--was one indication of the pressure. Early reports suggested that the notes had raised a considerable volume of new money. Other banks and financial intermediaries were watching closely with an attitude of mild concern. A recent go-around of thrift institutions in the Third District indicated that the impact of restraint varied among the types of institutions because of the differential returns they offered; mutual savings banks were feeling less of a pinch than savings and loan associations.

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But on the whole they seemed likely to weather the January withdrawals more easily than would be the case in some other areas.

The Philadelphia commercial banks also reported they were still under pressure, Mr. Bopp observed. They indicated, however, that the pressure was neither unexpected nor unmanageable, and several of them reported some weakening in loan demand. It was not clear whether that was because of a decline in demand for funds or because customers were aware that funds were not available.

Hopefully, Mr. Bopp said, it was an indication of the slowing now clearly apparent in the real sector of the economy. Since the last meeting, evidence of such slowing had increased at the District as well as the national level. The Philadelphia Reserve Bank staff, like others, estimated little, if any, real growth in GNP during the fourth quarter of 1969. It was forecasting declines in real GNP for the first two quarters of 1970, and perhaps the third quarter also. That was on the assumption that the Federal Reserve would remain firm in its efforts to root out inflationary expectations.

So far as he could see, Mr. Bopp continued, in spite of taut financial conditions and in spite of the slowdown in the economy, those expectations were still as strong as ever. Thus, it still appeared that business investment plans were rooted in continuing inflationary expectations. For the first time since September, for example, the Reserve Bank's Business Outlook Survey

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showed that more firms planned to increase capital spending over the next six months than planned a cutback.

As for policy in the coming weeks, Mr. Bopp was influenced by his experiences on the morning conference call since the last meeting. Once again he had been impressed with the skill of the Desk in achieving, under highly uncertain and rapidly shifting conditions, the money market conditions specified by the Committee. At the same time, he had also been impressed with the difficulties of achieving both stability in money market conditions and specified changes in the aggregates. At times during the past few months it had not been possible to do both. And if, as the Philadelphia Bank's staff was forecasting, the slowdown in the economy was well under way, the problem would intensify. That is, to achieve no change in money market conditions it would be necessary to accept or generate more weakness in the aggregates than the Committee might wish.

Mr. Bopp believed the Committee should guard against a premature and substantial shift toward ease. Nevertheless, he also believed it was time for the Desk to give more emphasis to achieving some consistent growth in the aggregates. Therefore, he would vote for alternative C of the draft directives.

Mr. Bopp observed that he had never been enamoured of Regulation Q. But even after listening to the comments around the

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table, he had no strong convictions as to the appropriate course with respect to interest rate ceilings at this time.

Mr. Kimbrel commented that, after the extensive discussion around the table this morning, about the only contribution he could make to an assessment of the state of the economy was to say that in the Sixth District, as elsewhere, evidence continued to accumulate of a slowdown in the rate of expansion in the last half of 1969. That slowdown was by no means universal among either sectors of the District's economy or geographical areas. As suggested in the Board staff's analysis of current economic and financial conditions, manufacturing activity had slowed most in the consumer-oriented industries. District primary and fabricated metals industries continued to expand strongly, on the other hand. Part of the latter might be explained by the fact that the District's metals industry was closely tied to heavy construction. Alabama was a leading State in the production of cast iron pipe used extensively in industrial construction, for example, and enough orders were on the books to keep the producers operating at capacity well into 1970. Income growth continued strong in Florida and Georgia, to some extent because of construction activity, but in the other four District States recent growth had been very modest.

Nevertheless, Mr. Kimbrel was convinced that some of the pressures producing inflationary conditions were losing their

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force. When he became impatient, he reminded himself that restrictions on the banking system had not become effective until the latter half of 1969. Consequently, he believed it would be premature to move toward a less restrictive policy at this time. However, he would not like to see the System, intentionally or unintentionally, move toward a more restrictive posture.

In practice, Mr. Kimbrel said, so long as policy was measured primarily by money market conditions, it was hard to judge whether policy at any moment was moving toward ease or restriction. That difficulty was especially great when, as he had indicated in his remarks at previous meetings of the Committee, distortions were occurring in the money market and in the allocation of credit because of the System's heavy reliance on Regulation Q ceilings. In addition, he had become increasingly disenchanted with Regulation Q, since it bore more heavily on some banks than others and because it led to the use of escape valves and a battle of wits between the bankers and the System and, in the process, discriminated against small businesses and individuals by diverting curtailed credit away from them. CD attrition was continuing at a high 30 per cent annual rate in the Sixth District, where the possibility of cushioning the impact of the decline of private CD's by sales to foreign official accounts was remote. Total deposits at the large Atlanta banks were down about 8 per

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cent from last year, with total time and savings deposits down 22 per cent.

Mr. Kimbrel recognized the possibility that a modification of Regulation Q might be interpreted as a general relaxation in policy or, if not carefully conceived, could turn out to be a move toward ease in practice. For the moment, therefore, the Board could perhaps afford to put off any action in raising ceilings on time and savings deposits of small depositors, although something might have to be done soon to maintain the banks' competitive position for passbook savings. Some of the distortions could be relieved without a general relaxation by raising ceilings on large denomination CD's--perhaps those of over \$200,000--while at the same time increasing reserve requirements on such CD's to the 10 per cent maximum. If such changes were announced at the same time that the proposed changes in regulations concerning commercial paper were imposed, any impression of a move toward ease would be dispelled.

It was especially difficult to decide on the appropriate directive in view of the distortions resulting from Regulation Q, Mr. Kimbrel said. However, if he had a choice he would favor alternative A.

Mr. Francis remarked that the staff had done an excellent job in the blue book of laying out three distinct alternative policies and the means by which each might be pursued: Policy A,

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"maintaining the prevailing firm conditions in the money market;" Policy B, "achieving slightly less firm conditions in the money market;" and Policy C, "firm conditions in the money market, monetary restraint, and modest and orderly expansion in the monetary and banking aggregates."

Alternative C seemed to Mr. Francis to be the appropriate directive. A policy of monetary restraint was needed, and consistent therewith it was no doubt appropriate that firm conditions continue in the money markets. But it was not desirable to continue that degree of monetary restraint and the extreme tightness in the money markets which had resulted in the upward thrust of interest rates of November and December. He believed, as alternative C suggested, that the Committee should undertake an increase of the money supply from December to March at not less than a 2 per cent annual rate. That meant that from now, the middle of January, to March the rate should probably be about 3 per cent. Following that procedure would turn back market interest rates, reversing the tightening of money market conditions which occurred late in 1969, but still keeping decidedly tight conditions.

Mr. Francis felt that the moderate monetary restraint of early 1969 had contributed to moderation of total spending after mid-year. The extreme monetary restraint of the past six months had contributed to the recent and current stagnation of

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real product and to the probable ensuing decline. Similarly, the desirability of reinstituting some monetary growth and backing away from the extreme money market tightness of November and December was dictated not by economic conditions today, but with an eye to what would be created for six, nine, and twelve months from now. Now the Committee had to choose. A continuation of recent policy would most likely produce, by year end, a real product decline at a 3 per cent rate and an unemployment rate of about 6 per cent. A moderate monetary growth, on the other hand, would most likely produce about a constant real product and a 5-1/2 per cent unemployment rate. In his opinion, the latter more moderate course would best contribute to long-run economic stability and moderation of the inflation.

Mr. Francis said he continued to favor abolition or relaxation of Regulation Q. While there was no apparent advantage to maintaining current ceilings, they did contribute to inequities, misallocation of resources, and a marked disruption of the financial system. Regulation Q had not contributed to monetary restraint, since funds found their way to users through other, though presumably less efficient, channels. It had seriously retarded the growth of banks, while a similar regulation had hampered the growth of savings and loan associations. Maintenance of Regulation Q required continuous policing and invited new regulations by the System to plug loopholes. Because of rate ceilings,

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the inefficient practice of giving premiums and services had been stimulated.

At the ceiling rates, Mr. Francis continued, small savings could not even maintain their purchasing power, and saving was discouraged. Regulation Q discriminated against small savers, and against consumers, home purchasers, and small businesses which had to rely on local institutions. It favored holders of large amounts of funds and large business borrowers who could use central money markets.

Mr. Francis thought a meaningful increase in Regulation Q ceilings would permit some bank reintermediation, but at the same time would be neutral so far as restraint on total spending was concerned. It would facilitate an upward change in growth rates of bank credit and M_2 but in the absence of complementary open market operations it would have little or no influence on M_1 .

Mr. Robertson made the following statement:

We all can agree that we are passing through a critical period for monetary policy. With the real economy leveling off, with cutbacks in production, jobs, and spending intentions becoming somewhat more widespread, and with financial pressures intense, there are grounds for arguing that the time has come to relax our credit restraint. If we were to judge by the yardsticks of the past, we could easily come to this conclusion.

But this is not a situation in which the usual rules--or even the latest in econometric models--can be trusted to serve as reliable guides. We are wrestling with a powerful, deep-seated, stubborn inflation--one outside the range of most past experience.

I believe that our policies in the past year have moved us well along the road to eventual victory in

this struggle, but it is by no means won yet. Prices and wages are still chasing each other upwards in a vicious spiral--and by more than can be explained away by simple assumptions as to the lagged effects of monetary restraint. There are signs all around us of persisting strong credit demands, of a kind that could quickly finance a new spending surge if we provided the reserves to finance it. If we give in too soon, we may well find that we have to begin the whole painful inflation-fighting job over again, and very possibly with resort to more distasteful controls than any we have used to date.

I know some feel that if we do not act to ease pressures significantly now, we will reap consequences which will impel us to ease too much later. But I think this line of argument gives too little weight to the strength of deferred demands, and to the ability of Federal Reserve officials to withstand public and political pressures to float away our troubles on a tide of easy money.

I know that the financial aggregates look weak, that interest rates are historically high, and that liquidity has been squeezed very low. I take these as good reasons for us to be careful not to tighten further in any of these areas. But I think anything we do to reserves or money market conditions to stop such further tightening has to be so limited as not to induce a relaxation of the general atmosphere of credit restraint that is our chief weapon in the battle to change the inflationary attitudes of businessmen and investors. Hopes for help from the fiscal front, I submit, are far too uncertain to be a basis for any different monetary strategy at this juncture.

Converting these general views to operational terms, I would want the Manager to be very gingerly and modest in any moves he makes. Given the range of error in our projections, I do not believe it is at all unlikely that we may find present money market conditions compatible with some small positive growth in money supply and no further net advance in market interest rates. I would like to have the Manager start out his operations in coming weeks on this presumption. Then, if events actually show that the money supply is on a falling trend or interest rates are rising markedly further, I would be willing to have him shade his operations toward the money market conditions associated with alternative C in the blue book for the next four weeks. On the other

hand, I would not ask him to fight any drop in interest rates that might develop because of possible shortfalls of credit demands.

On the basis of these understandings, I would be prepared to vote for alternative C for the directive. I believe it accommodates my views better than any of the other suggested choices.

Chairman Martin said he thought the time had clearly come for some adjustment in monetary policy. In his judgment the money market was as tight as it should be under any circumstances. On the theory that steel which bends is better than iron which breaks, he favored backing off slightly from the present posture. As Mr. Robertson had suggested, the move should be carried out in a gingerly fashion.

Chairman Martin remarked that on reviewing the directive drafts before today's meeting he had been quite impressed with alternative C; the policy course it called for was quite close to that he considered appropriate. He had heard nothing in the go-around to cause him to change that view. As he had indicated earlier, he did not think the language of C implied any commitment with respect to future policy. However, others might think the language was open to such an interpretation. Accordingly, he would be willing to vote for a directive calling for a policy course intermediate to those represented by alternatives A and B, if that was the preference of the majority.

The Chairman then said it might be useful to have further discussion of alternative C. He asked Mr. Holmes to comment.

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Mr. Holmes remarked that adoption of alternative C would pose some problems for the Trading Desk at the outset, although no doubt they could be worked out over time. The basic problem would be that of interpreting the Committee's intentions under various circumstances that might arise, given the need to keep two aggregates--money supply as well as bank credit--in view, and given the substantial revisions that were typical of the projections and even of the after-the-fact estimates. For example, at the opening of business tomorrow the Desk would have available estimates for the first week or two of the quarter and projections for the remaining weeks. However, as Mr. Keir had indicated, the Board's staff had already revised its projections for the month of January--strengthening that for the money supply and weakening that for bank credit; and the New York Bank's estimate for the January money supply was stronger still than the latest Board estimate. It was not clear to him how much weight the Committee would want to have placed on the movements in the money supply relative to those in bank credit if it adopted alternative C.

Perhaps, Mr. Holmes continued, the next revision would leave the bank credit projection also exceeding the target under C--possibly because of a sharp increase in bank-related commercial paper. He was not sure whether the Committee would want the Desk to react cautiously or aggressively in the event of such a development. A failure to seek tighter money market conditions might

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result in a substantial excess over target of the first-quarter growth rates; but caution might be indicated because the projections were uncertain and subject to large revisions.

Mr. Holmes added that if the interest in alternative C reflected mainly a desire to have greater weight placed on the performance of the aggregates, that purpose might be served in other ways. Specifically, the Committee could adopt alternative A and instruct the Desk to react quickly if the aggregates were not performing in the desired manner.

In response to the Chairman's request for comment, Mr. Partee said he agreed that alternative C would pose some problems for the Desk. As to the course to be followed if bank credit and the money supply deviated from target in opposite directions, his personal preference would be to give about equal weight to the performance of each aggregate in making operating decisions. However, since it was clear that not all members would agree with that approach, it would be desirable for the Committee as a whole to issue instructions on the point.

Secondly, Mr. Partee remarked, there was no question but that successive projections and estimates of the monetary aggregates frequently were modified substantially from the earlier figures. As a result, it was to be expected that in terms of the final figures the Desk would often be found to have missed the target appreciably for individual weeks, months, and even quarters--and perhaps for reasons

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that could not be explained easily. In his judgment the alternative C approach was feasible, but only if the Committee recognized that it would have to allow the Manager a substantial margin for error.

Finally, Mr. Partee agreed that one objective of alternative C could be served by adopting alternative A and calling for prompt and sizable reactions under the proviso clause. To make the instructions more nearly parallel, however, it would be desirable to add the money supply to bank credit in the proviso clause shown under A.

Mr. Keir added that in assessing the current performance of the aggregates it would be desirable to focus on the first quarter as a whole rather than on January and February alone. At this juncture a three-month horizon seemed particularly important for the money supply because of the large fluctuations expected in connection with the anticipated movements in the Treasury's balance.

Mr. Hayes said he would urge the Committee to recognize the difficulties it would be creating if it shifted to a new kind of directive at this time. It seemed to him there were two valid reasons for preferring alternative A to C. First, the difference between the projections under the two alternatives was rather minimal; as he understood it, the aggregates were projected to be only slightly stronger in February under C than under A. That small gain would be achieved at the cost of a move that was likely to be interpreted as a rather definite shift toward easing-- a cost he was not persuaded the Committee wanted to incur.

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Secondly, he thought a shift to the new type of directive would be premature at this point, in view of the kinds of potential problems that had been mentioned by Messrs. Holmes and Partee and in view of the fact that Mr. Maisel's committee had not yet reported its findings. As Mr. Holmes had suggested, the Committee could accomplish its objective by adopting alternative A and instructing the Manager to implement the proviso clause promptly if the aggregates were moving off target. He would consider the latter course much safer than that of adopting alternative C, and he would strongly recommend it.

Chairman Martin said it was his impression that the majority would prefer a directive intermediate to alternatives A and B, such as had been proposed by Mr. Brimmer, over alternative A.

Mr. Hayes remarked that he had been puzzled by Mr. Brimmer's proposal for the directive, which seemed to call for an overt move in the direction of easing. He (Mr. Hayes) would prefer not to take such a step, and he had thought Mr. Brimmer had indicated that he was loath to move away from the existing degree of restraint.

Mr. Brimmer commented that he favored taking the edge off of the prevailing restraint, but not shifting as far as implied by alternative B.

Mr. Mitchell said he would be satisfied with alternative B if the proviso clause were modified in two respects. First, he

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would favor a two-way clause, since he would be just as disturbed by excessive growth in the aggregates as by shortfalls. Secondly, the proviso clause should include a reference to the money supply. Given the present uncertainty regarding possible action on Regulation Q, it was not possible to make meaningful predictions of the course of the bank credit proxy. Thus, the Manager would have difficulties in making decisions unless he could consider money supply behavior also.

Mr. Hayes said he was quite willing to have the proviso clause formulated in terms of the money supply as well as bank credit.

Mr. Daane said he was troubled by the suggestion that the Committee should adopt certain rather precise targets for the monetary aggregates, particularly since the Board might well make some regulatory changes shortly that would have important consequences for the aggregates. For example, the projections the staff had indicated were consistent with Mr. Brimmer's proposed directive language assumed no change in Regulation Q. If the Committee accepted those projections as targets and the aggregates significantly exceeded them because of Board action on Q, would the Manager have to tighten money market conditions? It was because of that kind of problem that he would prefer following a more conventional approach today. He thought most of the Committee members had more or less the same objectives in mind with respect to the aggregates, and were searching for the best means for

formulating those objectives in the directive. He favored the course Mr. Hayes had suggested, on the understanding that the Manager would take into account any regulatory changes that might be made.

Mr. Brimmer said that he had mentioned the staff's projections of the aggregates under his proposal for a directive intermediate between A and B for illustrative purposes only, and had not intended that the Committee accept them as targets for operations.

Mr. Maisel said he would like to make several points. First, he agreed with the Chairman that no policy action taken would commit the Committee beyond the coming inter-meeting interval. Secondly, by his count a majority of the members wanted to change policy today. Third, he agreed that it would be desirable to have a two-way proviso to guard against a runaway expansion of bank credit. All things considered, he was willing to support Mr. Brimmer's proposed language calling for "achieving a slightly lessened degree of restraint in money market conditions" with a two-way proviso referring to both money and bank credit. Such a directive would appear to him to represent the consensus of the meeting, or at least the middle ground of the views expressed.

Mr. Galusha said he thought it would be a mistake to formulate policy today on the basis of a possible Regulation Q change, the nature of which was not presently known. It would be better to plan on holding an interim meeting after a decision had been made on

Regulation Q, if that seemed desirable at the time. Meanwhile, he would recommend that the Committee adopt alternative B with a symmetrical proviso clause.

Mr. Sherrill said he found Mr. Brimmer's proposed directive language to be satisfactory. However, he would still favor instructing the Manager to implement the proviso clause sooner and more aggressively than normally if there were shortfalls in the aggregates.

Mr. Daane noted that an increase in the Regulation Q ceilings presumably would lead to more growth in the aggregates than projected in the blue book. In light of that factor, it might be desirable to modify Mr. Brimmer's proposed language to call for "permitting" rather than "achieving" a slightly lessened degree of restraint.

In response to the Chairman's request for comment, Mr. Holmes said there were, no doubt, various ways in which the directive could be formulated. It was quite clear that the Committee favored some modest growth in bank credit and money, but he assumed that it would be agreeable to the members if that could be accomplished with no change in money market conditions, as he thought was quite possible. One possibility was a second paragraph beginning as follows: "To implement this policy, while taking account of the forthcoming Treasury refunding, possible bank regulatory changes and the Committee's desire to see a modest growth

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in money and bank credit, System open market operations shall be conducted with a view to maintaining the prevailing firm conditions in the money market;". The paragraph would then continue with a two-way proviso clause referring to both money and bank credit.

Mr. Maisel suggested that the language proposed by Mr. Holmes would be acceptable to him if the words "the prevailing" were deleted from before the phrase "firm conditions in the money market."

In the course of further discussion it was agreed that Mr. Holmes' proposal, with the modification suggested by Mr. Maisel, would be appropriate for the second paragraph. It was also agreed that the concluding sentence of the first paragraph should be unchanged from the previous directive except for the insertion of the word "orderly" before "reduction of inflationary pressures," as suggested in alternatives B and C of the staff's drafts.

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

The information reviewed at this meeting suggests that real economic activity leveled off in the fourth quarter of 1969 and that little change is in prospect for the early part of 1970. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have receded from highs reached during December. Bank credit and the money supply increased slightly on average in December and also over the fourth quarter as a whole.

Outstanding large-denomination CD's held by domestic depositors have continued to contract in recent months while foreign official time deposits have expanded considerably. Flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there apparently were sizable net outflows after year-end interest crediting. U.S. imports and exports have both grown further in recent months but through November the trade balance showed little or no further improvement from the third-quarter level. At the year end the over-all balance of payments statistics were buoyed by large temporary inflows of U.S. corporate funds. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the orderly 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, while taking account of the forthcoming Treasury refunding, possible bank regulatory changes and the Committee's desire to see a modest growth in money and bank credit, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market; provided, however, that operations shall be modified if money and bank credit appear to be deviating significantly from current projections.

Chairman Martin then noted that the Committee had planned to continue its discussion today of the possible release of its minutes for the years 1962 through 1965, and that the Secretariat had distributed a memorandum on that subject on January 8, 1970.^{1/} He asked Mr. Broida to comment.

Mr. Broida observed that the memorandum of January 8 presented the staff's final recommendations regarding passages to be withheld when the 1962-65 minutes were initially transmitted

^{1/} A copy of this memorandum, entitled "Passages recommended for deletion when 1962-65 FOMC minutes are released," has been placed in the Committee's files.

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to the National Archives. It also gave the text of the proposed footnotes indicating the substance or the subject of each deleted passage, and a draft of a prefatory note to be included in the minutes for each year listing the reasons for which deletions had been made.

Since the memorandum was prepared, Mr. Broida continued, the Bank of England had requested that three of the footnotes be modified slightly. Otherwise, the staff had no changes to propose in the recommendations as set forth in the memorandum. If the Committee so decided, it should be possible to release the minutes in question some time next week.

Mr. Mitchell said he was inclined to question the desirability of two types of deletions the staff was recommending. The first was certain remarks made by a staff member, mainly in the course of presenting reports on the balance of payments situation. The second type involved certain material regarding window dressing operations.

Mr. Broida said the desirability of deleting the staff remarks to which Mr. Mitchell had referred was not clear-cut. However, as noted in the memorandum, it was believed that the balance of considerations argued in favor of their deletion. As to the passages relating to window dressing, he recalled one which the Bank of England had requested be withheld at this time.

Mr. Mitchell noted that there was a second case also, involving the Bank of Canada. While he was prepared to give weight to the desires of foreign central banks, he wondered whether further study might not suggest a better way of dealing with the problem.

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Mr. Daane said his personal inclination would have been to withhold somewhat more material than the staff had proposed. However, he was willing to accept the staff's recommendations as a compromise between Mr. Mitchell's views and his own.

Mr. Brimmer said he thought the staff's recommendations were appropriate. He proposed that the Committee accept them and agree to the transmittal of the minutes in question to the National Archives as soon as feasible.

Chairman Martin asked whether there were any objections to the course Mr. Brimmer had proposed, and none was heard.

By unanimous vote, transfer to the National Archives of the minutes of the Committee for the years 1962-65, inclusive, on the basis described in a memorandum from the Secretariat dated January 8, 1970, was authorized.

Chairman Martin said he would again like to thank everyone present for the help they had given him over the years.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, February 10, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.


Secretary

CONFIDENTIAL (FR)

January 14, 1970

Drafts of Current Economic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on January 15, 1970

Alternative A

The information reviewed at this meeting suggests that real economic activity leveled off in the fourth quarter of 1969 and that little change is in prospect for the early part of 1970. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have receded from highs reached during December. Bank credit and the money supply increased slightly on average in December and also over the fourth quarter as a whole. Outstanding large-denomination CD's held by domestic depositors have continued to contract in recent months while foreign official time deposits have expanded considerably. Flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there apparently were sizable net outflows after year-end interest crediting. U.S. imports and exports have both grown further in recent months but through November the trade balance showed little or no further improvement from the third-quarter level. At the year end the over-all balance of payments statistics were buoyed by large temporary inflows of U.S. corporate funds. 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 laying the base for sustainable economic growth and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing firm conditions in the money market; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Alternative B

The information reviewed at this meeting suggests that real economic activity leveled off in the fourth quarter of 1969 and that little change is in prospect for the early part of 1970. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have receded from highs reached during December. Bank credit and the money supply increased slightly on average in December and also over the fourth quarter as a whole.

Outstanding large-denomination CD's held by domestic depositors have continued to contract in recent months while foreign official time deposits have expanded considerably. Flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there apparently were sizable net outflows after year-end interest crediting. U.S. imports and exports have both grown further in recent months but through November the trade balance showed little or no further improvement from the third-quarter level. At the year end the over-all balance of payments statistics were buoyed by large temporary inflows of U.S. corporate funds. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to an orderly 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, while taking account of the forthcoming Treasury refunding, 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 further if bank credit appears to be significantly weaker than currently projected.

Alternative C

The information reviewed at this meeting suggests that real economic activity leveled off in the fourth quarter of 1969 and that little change is in prospect for the early part of 1970. Prices and costs, however, are continuing to rise at a rapid pace. Most market interest rates have receded from highs reached during December. Bank credit and the money supply increased slightly on average in December and also over the fourth quarter as a whole. Outstanding large-denomination CD's held by domestic depositors have continued to contract in recent months while foreign official time deposits have expanded considerably. Flows of consumer-type time and savings funds at banks and nonbank thrift institutions have remained weak, and there apparently were sizable net outflows after year-end interest crediting. U.S. imports and exports have both grown further in recent months but through November the trade balance showed little or no further improvement from the third-quarter level. At the year end the over-all balance of payments statistics were buoyed by large temporary inflows of U.S. corporate funds. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to an orderly reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

Accordingly, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market, consistent with a policy of monetary restraint and conducive to modest and orderly expansion in the monetary and banking aggregates.