MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 10, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, 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, Hickman, and Swan, Alternate Members of the Federal Open Market Committee

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

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

Mr. Bernard, Assistant Secretary, Office of the Secretary, Board of Governors
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. Hilkert and Black, First Vice Presidents of the Federal Reserve Banks of Philadelphia and Richmond, respectively
Messrs. Eisenmenger, Parthemos, Taylor, Jones, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, St. Louis, and San Francisco, respectively
Mr. Hocter, Vice President, Federal Reserve Bank of Cleveland
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

Vice Chairman Hayes noted that a vacancy existed in the office of Chairman of the Committee since Mr. Martin's official connection with the Committee had ceased on January 31, 1970, when his term as a member of the Board of Governors had expired.

By unanimous vote, Arthur F. Burns was elected Chairman of the Federal Open Market Committee to serve until the election of his successor at the first meeting of the Committee after February 28, 1970, with the understanding that in the event of the

discontinuance of his official connection with the Board of Governors during that period, he would cease to have any official connection with the Federal Open Market Committee.

Chairman Burns remarked that in his judgment economic developments had reached a point at which a rethinking of monetary policy was in order. It was the Committee's task today to attend to today's problems and to those of the future as best they could be discerned. Just as military campaigns had been lost because the generals were fighting yesterday's wars, monetary policy could go wrong if it were formulated on the basis of past rather than current and prospective conditions.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on January 15, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on January 15, 1970, 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 January 15 through February 4, 1970, and a supplementary report covering the period February 5 through 9, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that there had been three major developments in the foreign exchange markets since the Committee's last meeting. First, the seasonal strengthening of sterling finally had developed in mid-January and the Bank of England had been able to take in well over $600 million since then. That had facilitated British debt repayments; he was happy to report that the remaining $350 million due to the System under its swap line with the Bank of England would be fully paid off tomorrow (February 11). The line had been in continuous use since July 1, 1968, much longer than the one-year limit the Committee normally liked to apply. However, the System had been dealing with an unusually difficult situation. If it had not provided financing to the British the international financial world undoubtedly would have been quite different today.

Secondly, Mr. Coombs remarked, speculative talk of a revaluation of the Swiss franc was growing. Such talk probably was frustrating the usual seasonal outflow of funds from Switzerland and thereby delaying liquidation of the Federal Reserve's $125 million drawing on its swap line with the Swiss National Bank. The German mark revaluation had had an inflationary effect on Switzerland, first by increasing the cost of Swiss imports from Germany and secondly by stimulating expansion of the Swiss export industries. The Swiss National Bank had proposed a 5 per cent revaluation at the time of the German move but that had been rejected in favor of a proposal to

require exporters to deposit 5 per cent of the export proceeds in a non-interest-bearing account at the Swiss National Bank. Now the Swiss Government was backing away from the export deposit scheme, and that might bring the revaluation issue once more to the fore. In any event, the exchange markets could readily see which way the directional signals were pointing and there might be sizable speculative flows of funds to Switzerland over coming months. He would be reasonably sure, however, that the Swiss authorities would prove cooperative in finding a solution to that problem.

Mr. Coombs observed that speculative guessing on a revaluation of the Swiss franc probably was also contributing to heavy selling pressures on the Italian lira. Since year end, the Bank of Italy had lost nearly $600 million and had been forced to draw $400 million on its swap line with the System, leaving $600 million available. At the Bank for International Settlements meeting last weekend, an official of the Bank of Italy had expressed grave concern over the immediate political and financial outlook in his country. Very heavy capital outflows from Italy were now being aggravated by a weakening of the trade account as wage increases in industry were moving up to around 20 per cent.

As the Committee knew, Mr. Coombs continued, the Italian Government had resigned over the weekend. Even in the absence of an effective government, however, there were quite a few defensive measures the Bank of Italy might take to stabilize the situation.

If that were done, the System might at some stage find it useful to participate in an international credit package designed to restore confidence in the lira, perhaps also involving the U.S. Treasury and European central banks. The Committee would recall that the last such credit package for the lira, in 1964, had proved extremely successful. His purpose in mentioning those problems was simply to alert the Committee to impending trouble; he did not recommend any policy action at this time.

In reply to a question by Mr. Brimmer, Mr. Coombs said it was possible that the Italian situation would come to a head before the next meeting of the Committee. On balance, he thought the Italians probably would be able to cope with the problem even if they suffered relatively severe losses. In view of the risks, however, it might be well for him to discuss the situation with the U.S. Treasury.

Mr. Daane remarked that Mr. Coombs had been wise in alerting the Committee to the potential problems in that area. In preliminary discussions of the matter officials of the U.S. Treasury had noted that the Italians had substantial resources available, including drawing rights under their gold and super-gold tranches in the International Monetary Fund. Accordingly, there was some question at the Treasury as to whether it would be necessary to provide additional credit facilities. Of course, such situations could change rapidly.

In reply to questions by Mr. Hickman, Mr. Coombs said the Italians would be able to draw nearly $1.5 billion on the Fund. In addition, a new facility had been introduced in the Common Market providing for a central bank pool for purposes of short-term borrowings, under which the Italians could draw up to $200 million. Finally, in light of the inflows to Switzerland, the Swiss might also be willing to extend credits to them. Thus, a great deal of money could be available to the Italians. At some point it might be desirable to talk with other potential creditors about what concerted action might be taken if Italy got into difficulty. While the Italians faced some basic political and economic problems there was a great deal they could do to defend the lira; for example, interest rates in their money markets were still below those in the other markets and could be raised. He would not regard the situation as one in which a breakdown was inevitable. Indeed, he expected the Italians to draw on the great resilience they had demonstrated in the past and resolve their present difficulties.

By unanimous vote, the System open market transactions in foreign currencies during the period January 15 through February 9, 1970, were approved, ratified, and confirmed.

Mr. Coombs reported that two drawings by the Federal Reserve on the National Bank of Belgium would reach the end of their first three-month terms soon--a $25 million drawing on

February 25, 1970 and a $15 million drawing on March 2. He doubted that it would prove possible to acquire enough Belgian francs to repay those drawings by their maturity dates, and accordingly he recommended their renewal for another three-month term if necessary.

Renewal of the two drawings on the National Bank of Belgium was noted without objection.

Mr. Coombs then noted that two memoranda[1/] had recently been distributed to the Committee in connection with the inquiry of the Central Bank of Ireland about joining the System's swap network. He thought Mr. Reynolds' memorandum provided an excellent summary of the pros and cons of adding Ireland to the network. Mr. Reynolds had not come to any conclusion in the matter and his (Mr. Coombs') position was also rather inconclusive. On balance, however, and by a slight margin, he was inclined to favor inclusion of the Central Bank of Ireland in the network, with a swap facility of $50 million. In his judgment such a step was not likely to expose the System to a large number of applications from other small countries or to serious risks of other types.

1/ The first of these memoranda, by Mr. Reynolds of the Board's staff, was entitled "Ireland as a candidate for a reciprocal currency arrangement with the Federal Reserve," and dated December 16, 1969; it was distributed to the Committee under date of January 26, 1970. The second, by Mr. Kohn of the Board's staff, was entitled "Recent economic and financial developments in Ireland," and was dated February 4, 1970; it was distributed on that date for background purposes. Copies of both memoranda have been placed in the Committee's files.

In reply to a question by Mr. Mitchell, Mr. Coombs said he agreed with Mr. Reynolds' judgment that the Central Bank of Ireland seemed to meet three of the four criteria for membership in the swap network that had been suggested in a staff paper of February 1967. Specifically, Ireland's currency was convertible within the meaning of Article VIII of the Articles of Agreement of the IMF; the Bank of Ireland presumably would be willing and able to enter into a swap arrangement on the same basis and understandings as other participants in the network; and Ireland's financial structure probably was as well developed and as susceptible to disequilibrating international payments flows as that of such present members of the network as Mexico, Norway, Denmark, and Austria. There was a question, however, as to whether the fourth criterion, regarding size, was met. Ireland's official reserves recently had been at least as large as those of several present members, but its foreign trade, IMF quota, and population all were smaller than those of any member.

Mr. Maisel asked whether a basic problem was not posed by the fact that Ireland lacked well-developed money and capital markets, as noted in Mr. Kohn's memorandum.

In reply, Mr. Coombs observed that a number of the other countries whose central banks were in the network also did not have well-developed money and capital markets. That was the case, for example, with respect to Mexico and Denmark, and perhaps Switzerland as well. The more important consideration, in his judgment, was

that Ireland--like others in the network--was exposed to major losses of reserves through changes in payment leads and lags, borrowings by foreigners in Ireland, and repatriation of export proceeds.

Mr. Coombs added that the case in favor of including Ireland in the network was certainly a marginal one although, as he had indicated earlier, he thought the pros slightly outweighed the cons. Whatever the Committee's inclination, it would be helpful if he could report it to the Irish authorities.

Mr. Daane suggested that it might be useful to pursue the discussions with the Irish while maintaining a neutral posture with respect to the Committee's probable final decision.

Mr. Robertson said he thought the Committee should move very slowly in adding central banks to the swap network, particularly those of countries as small as Ireland, in view of the possibility that that step would lead to a number of other such requests. In general, any proposed addition should be evaluated in terms of whether it would further the purposes for which the network had originally been established. He thought it would be appropriate for Mr. Coombs to consult further about the matter with the Irish, but to avoid suggesting whether the Committee's decision was likely to be favorable.

Mr. Hickman remarked that his views were similar to Mr. Robertson's. The System's swap network already included the central banks of 14 countries, and many others might consider themselves

qualified for admission if Ireland were included. He would be concerned about the administrative problems that would be encountered if the network were substantially enlarged.

Mr. Coldwell said it was his tentative judgment that a swap arrangement with the Bank of Ireland would represent an undesirable precedent in view of the small size of that country.

Chairman Burns observed that he also had some doubts about the desirability of a swap arrangement with the Bank of Ireland. He thought the question warranted further study, and proposed that the Committee defer action for the time being.

Mr. Hayes asked whether it would be appropriate for the Special Manager to discuss the question further with the Irish authorities, while remaining neutral with respect to the Committee's probable decision.

Chairman Burns expressed the view that such discussions would be quite appropriate, although Mr. Coombs might want to bear in mind the rather negative tone of some of the comments made today.

In a concluding observation, Mr. Coombs said he would suggest that the System begin some contingency planning sessions with the U.S. Treasury regarding not only the risk of a crisis in the Italian lira but also the possibility of new troubles for sterling. First, an effort might be made to learn to what extent the Treasury would be prepared to join with the System in extending credit to the British and Italians in event of need. The Treasury did have

funds--currently about $550 million--available for such purposes, and another allocation of $750 million of SDR's would come along at year end. In his judgment they could and should join with the System in any emergency operation.

Secondly, Mr. Coombs thought discussions should be held with both the U.S. Treasury and the Bank of England about the priority the Bank of England would give to repaying any new credits extended by the Federal Reserve relative to repayments of other debt falling due in 1970. As of the moment, the British had already scheduled debt repayments of $1.8 billion over the rest of 1970. Some of those repayments might be postponable and others not; but the System should know where it stood in the queue of Britain's creditors in view of its exposure to unconditional British drawings on the $2 billion swap line. While sterling was strong at the moment, he thought it would be prudent to plan against the possibility of problems arising during the coming year.

Chairman Burns said he would have assumed that the System would be engaged in contingency planning as a matter of course and that the Special Manager would not need the approval of the Committee to engage in such discussions with the Treasury.

Mr. Daane observed that there was an inter-agency group continually engaged in such contingency planning, to which Mr. Coombs regularly reported regarding potential problems. He (Mr. Daane) assumed that Mr. Coombs' purpose in suggesting the need for such

planning now was to alert the Committee to possible difficulties ahead. His own feeling was that Mr. Coombs had earned the Committee's gratitude for arranging the repayment in full of the Bank of England's swap debt to the System. At the same time, he agreed that the System should be discussing with the Treasury the courses that might be followed if there were further difficulties for sterling.

Chairman Burns remarked that in his judgment it was vitally important for the Government to engage in contingency planning in the economic and financial spheres. Accordingly, he would hope Mr. Coombs would undertake the conversations suggested.

Mr. Brimmer asked whether Mr. Coombs wanted guidance from the Committee on any specific questions that might arise in the discussions.

Mr. Coombs said he would appreciate guidance on the two matters he had touched on. With respect to the first, some members of the Committee had suggested at times in the past that it would be desirable for the Treasury to take over foreign central bank debt to the System that threatened to run on for too long. His own view was that a more fruitful approach would be to arrange for the Treasury to share the original burden of such credits with the Federal Reserve, rather than taking them over later. The second matter related to the Committee's general view that credits under the swap network should be short-term in nature. Since credits under the

swap line were renewable, he thought it was important that the System have a very high priority in the repayment pattern if the Bank of England made further drawings on the swap line. Unless that was understood in advance there was a risk that the System would not be repaid until after the $1.8 billion scheduled for repayment in 1970 was cleared off the books.

Mr. Coldwell recalled that at the Committee meeting on September 9, 1969, the staff had been asked to prepare a memorandum on the System's swap network, including analysis of such matters as its basic purposes, uses, and problems. The memorandum presumably would consider questions related to those Mr. Coombs had just raised, including that of possibly attaching conditions under certain circumstances to swap drawings on the System. He asked about the status of the staff study requested.

Mr. Coombs replied that the memorandum in question was still in preparation. He regretted the delay in its completion and was sure that the Board staff members involved did also.

Mr. Daane said he thought that at this juncture the Committee could not give Mr. Coombs any firm instructions on the matter raised, and that it might simply suggest that he discuss them fully with the Treasury. There were some aspects that would need to be considered carefully; for example, if the Treasury were to share in the burden of certain credit extensions from the beginning, the

question might arise as to whether the System should have priority over the Treasury in any repayments.

Chairman Burns concurred in Mr. Daane's suggestion that Mr. Coombs discuss the matters in question with the Treasury. The Chairman then invited Mr. Daane to comment on the meeting in Basle from which he had just returned.

Mr. Daane remarked that there were only a few points of interest with respect to the meeting in Basle over the past week-end. The formal session on Sunday afternoon was quiet and not very productive. The only aspect worth noting was the marked divergence among countries as to how SDR's should be treated in their balance of payments accounts. At one end of the spectrum was the French view that SDR's were worth little more than a footnote in their international accounts; at the other end was the U.S. view that they were a true reserve asset and that they should show up in the balance of payments accounts.

At a working lunch on Sunday, Mr. Daane continued, the discussion centered on the possibility of an international meeting to discuss interest rate levels. Some weeks ago Mr. Schiller, the German Economics Minister, had publicly proposed such a meeting, and the French Minister of Finance, Mr. d'Estaing, reportedly also favored one. The Secretary General of the OECD, Mr. Van Lennep, who had come to Basle for the purpose of reviewing various procedural alternatives, outlined a procedure for discussions within

the framework of the OECD, looking toward a May meeting of the Ministers and Governors on possible coordinated action to deal with interest rate levels. The Governors reacted negatively to the idea that they should participate in a meeting of that type. However, they thought it might not be harmful for the Ministers, meeting informally by themselves, to consider the subject, along with other problems, at their May meeting; and for an interim WP-3 meeting to include on its agenda discussion in some detail of current interest rate levels and their implications.

Mr. Daane noted that the discussion at the dinner meeting on Sunday concerned U.S. monetary policy. Those present were almost unanimously of the view that the Federal Reserve should not ease its stance at this time. Although he had commented on the U.S. situation, he was not sure that the participants fully appreciated the extent to which the economic expansion had already slowed or the degree of austerity in the proposed budget. No doubt their attitude toward U.S. policy reflected their own continuing fears of inflation.

Mr. Brimmer commented that as the Board member to whom responsibility had been delegated for the voluntary foreign credit restraint program, from time to time he had reported on the program to the Committee. Data now available for 1969 indicated that banks had increased their holdings of foreign assets by about $150 million,

in contrast to a reduction of more than $600 million in 1968. During most of the year such holdings had followed a seesaw pattern, and they rose substantially in December--by nearly $320 million.

Mr. Brimmer noted that today marked the fifth anniversary of the program. In a speech he would be delivering in Dallas tomorrow he planned to present an assessment of what had been achieved, and to raise certain questions about the efficacy of a program based on administrative decisions and guidelines. In particular, he would be asking whether an effort should not be made to develop more market-oriented techniques, perhaps involving cash reserve requirements against foreign assets of U.S. banks.

In reply to an inquiry by Chairman Burns, Mr. Solomon said he had planned to report to the Committee today on the Working Party 3 meeting he had attended in mid-January. In the interest of time, however, he would simply submit his report for inclusion in the record. He submitted the following report:

> At its meeting in mid-January, Working Party 3 once again discussed the Euro-dollar market and in particular the danger that Europe might be swamped by a reflow of dollars if U.S. banks began to repay borrowings from their branches in substantial amounts. As Otmar Emminger, Chairman of the Working Party, put it, Europe sees itself between twin dangers: one, that the Federal Reserve might keep monetary policy too tight in order to prevent a large outflow of short-term funds; two, the danger that Europe will be flooded with dollars when U.S. monetary policy eases.
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> In the course of the discussion, Regulation Q once again came in for considerable criticism. Some delegates went so far as to say that there would not be a Euro-dollar market if it were not for Regulation Q. This

quasi-philosophical question was not resolved. We did, however, try to make it clear that the United States would probably have attracted a substantial volume of funds from abroad in 1969 even if neither Regulation Q nor the Euro-dollar market existed.

On the dangers of a massive outflow of short-term funds from this country in 1970, several points were made, some by us and some by delegates of other countries.

1. The nature of the swamping of Europe with dollars, to which Dr. Emminger referred, was clarified. What could happen is that U.S. interest rates might decline while rates within European countries remain high. This could lead to a repayment of Euro-dollar borrowings by U.S. banks. As the foreign holders of Euro-dollar deposits reconvert into their own currencies, there would be a sizable increase in dollar reserves of European central banks and an increase in domestic liquidity that European central banks might find it difficult to offset.

2. It follows that these dangers will be lessened to the extent that European central banks find it possible to take steps to lower domestic interest rates as or even before U.S. rates come down. Since a number of European monetary officials have complained that they were forced by high Euro-dollar rates to raise domestic rates above levels they regarded as desirable in 1969, it is not unreasonable to expect them to lower their rates as Euro-dollar rates come down.

3. It was also pointed out that the Federal Reserve's marginal reserve requirement on Euro-dollar borrowings contains a disincentive to massive repayment by American banks.

4. It was further pointed out that a number of European central banks could put dollar receipts to good use: to repay debt to the United States, as in the case of France and Britain, to repay debt to the IMF (which does, of course, reduce U.S. reserves), or simply to restore depleted foreign exchange holdings, as in the case of Germany and Italy.

5. Finally, even if the general view was that Euro-dollar reflows are unlikely to cause any sort of crisis this year, a basic question regarding the U.S. balance of payments position remains. Euro-dollar flows have financed an underlying U.S. deficit and kept the dollar strong. As this protection disappears the underlying deficit will re-emerge and there is no great confidence that this problem is on the way to lasting solution.

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 January 15 through February 4, 1970, and a supplemental report covering the period February 5 through 9, 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:

> Over the period since the Committee last met--a period highlighted by a major Treasury refunding--interest rates have had their ups and downs, particularly the latter. Late in the period strong expectational forces--generated partly by indications of a weakening economy but primarily by hopes of an early easing in monetary policy--tended to bring about a sharp decline of interest rates in all maturities.
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> Over the period the market had to assess the Board's changes in Regulation Q, the proposed change that would bring commercial paper under Regulation D, and the President's budget and Economic Report. There was, in fact, little market reaction to either the Board's moves on Regulations Q and D or the budget. On the whole the raising of Q ceilings on large-denomination CD's was viewed as having a negligible effect on banks' current ability to attract CD money, but as bringing nearer the day when banks could hope for an end to the process of disintermediation. The change in rates on consumer type CD's was viewed as helping banks and thrift institutions to mitigate further outflows into higher yielding market instruments, but at a significant cost in profits. And there was a sigh of relief that the Board did not bring bank-related commercial paper under Regulation Q. The proposal to assess reserve requirements on bank-related commercial paper was viewed as a potential added cost, but more hopefully as a shift away from the use of interest rate ceilings as a method of monetary and credit control.
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> Neither the President's economic message nor the budget carried any real surprises for the market. While the proposed budget for 1971 was generally viewed as constructive, there was considerable skepticism over the realism of the expenditure estimates. The testing

period for the budget--in the market view--will come only when the various spending programs come before Congress.

While the market's reaction to the Board's moves and to the budget was neutral, there were heightened expectations towards the close of the period that monetary policy would ease. Early in the period since the Committee last met there was some easing in interest rates, reflecting increasing signs of economic weakness as well as the usual relaxation of money market pressures in January. But with new indications of heavy private credit demands, typified by the A.T.&T. announcement of a $1.6 billion financing, and with congestion in the municipal market and a major Treasury refunding near at hand, the decline in rates was short-lived. Over the weekend at the turn of the month, however, press reports of President Nixon's remarks at the installation of Chairman Burns--strengthened a few days later by an optimistic interpretation of a comment by Secretary Kennedy--suggested to many market participants that monetary policy might soon become less restrictive. There was an immediate reaction in all markets, interest rates moved lower, and the Treasury refunding turned out to be an outstanding success. Further official comment over the last weekend has tended to strengthen market expectations that a shift in monetary policy lies just ahead.

In its refunding of $6.7 billion of securities (of which $5.6 billion were held by the public) maturing on February 15 and March 15, the Treasury offered attractive terms. Included in the offering were an 8-1/4 per cent 18-month note, an 8-1/8 per cent 3-1/2 year note, and an 8 per cent seven-year note; these rates were 1/4 to 1/2 percentage points above those applied to a similar offering last September and the highest in modern times. The market reaction to the terms was generally favorable, and the new issues immediately traded at a moderate premium in the when-issued market. On Monday, February 2--the day the books opened on the refunding--prices of all Treasury coupon issues rose sharply in response to the President's remarks. By Wednesday, when the books closed, all three new issues were trading at a premium of 19/32. Prices have strengthened substantially further since then, so that yields on the bid side of the market were about 5/8, 3/8, and 1/4 percentage points, respectively, lower than the original offering terms.

Given the favorable circumstances there was a large dealer response in the refunding and a sizable amount of speculative interest; and a number of banks, which had been smarting under the changes in capital gains treatment accorded them in the recent tax reform bill, changed their minds and decided to make the exchange. Attrition,

preliminarily estimated at $863 million, was only about half the maximum the Treasury had been prepared to accept, although it was still about 15 per cent of public holdings. The System exchanged its holdings of $681 million of the maturing securities for $281 million of the 8-1/4's and $200 million each of the longer-term notes. As usual, we tried to pattern our exchange to the expected public subscriptions to the new issues, and we came surprisingly close to matching that pattern.

The marked change in expectations affected short-term as well as long-term interest rates, with the three-month Treasury bill rate declining 1/2 percentage point from the high reached in late January. In yesterday's regular Treasury bill auction, average rates of 7.31 and 7.39 per cent were established for three- and six-month bills, down 52 and 39 basis points from the rates set in the auction just preceding the last meeting of the Committee.

While there were many interesting developments in the markets, the main concern at the Trading Desk was the proper implementation of the Committee's directive, with its new emphasis on monetary aggregates--on the money supply and on bank credit. Developments since the last meeting of the Committee illustrate, I believe, many of the problems that we will face if the Committee wants to shape day-to-day operations with a view to gaining greater control over movements of the aggregates. These problems involve (1) divergence between movements in the aggregative measures that the Committee is primarily interested in; (2) divergence between actual developments, as best they can be measured, and earlier projections; (3) the weight to be placed on current developments as opposed to expectations of the future and the subsidiary problem of differences in the projections made by the Board staff and at the New York Bank; and (4) how far to modify money market conditions in either direction if the Committee's desires with respect to the aggregates are not being met. While we may not need final answers to these questions before moving further in the direction of greater attention to the aggregates, it is clear that all of these questions involve much further study, both at the staff level and at the Committee level. I am sure that they will not or cannot be resolved without a period of considerable experimentation.

In reviewing developments since the last meeting, it might be helpful to start with an interpretation of the directive adopted by the Committee at that time. It appeared quite clear that the Committee wanted to see a modest growth in money supply and bank credit over the first quarter of the year--with a 2 per cent growth rate generally viewed as appropriate. About equal weight was given to money supply and to bank credit, although a

number of Committee members recognized that it would be difficult for bank credit to grow as long as Regulation Q inhibited the ability of banks to raise funds through the issuance of large-denomination CD's. If these results were achievable with prevailing money market conditions this was acceptable to the Committee, but if the aggregates appeared to be weaker than desired, there was a clear consensus that money market conditions should be eased--i.e., we should move to a lower Federal funds rate, lower net borrowed reserves, and lower borrowings from the Reserve Banks. Little attention was paid to the possible need to tighten money market conditions if the aggregates turned out to be stronger than the Committee desired, although some members emphasized their desire to see any growth in the monetary and credit aggregates kept modest.

Staff projections contained in the blue book1/ indicated at that time that, given prevailing money market conditions, money supply would show no growth in January and little for the first quarter, although Mr. Keir noted that new data might show somewhat greater strength for January. The credit proxy--on the same assumption--was expected to decline at a 1 to 4 per cent annual rate in January, and at a roughly similar rate over the quarter. On the day following the meeting, money supply estimates for January were revised upward to a 4 per cent annual growth rate; a week later they were revised upward to 11 per cent. Currently, it is estimated that money supply grew at a 9 per cent annual rate in January. For the quarter--that is, December to March--the Board staff is forecasting a 3-1/2 per cent growth rate and the New York Bank staff a 4-1/2 per cent growth rate. Bank credit--measured by the proxy adjusted for nondeposit sources of funds--is currently estimated to have declined at about a 3 per cent annual rate in January, and forecasts range from a 3-1/2 per cent rate of decline for the first quarter, according to the Board staff, to the New York Bank's somewhat more pessimistic estimate of a 4-1/2 per cent rate of decline.

Given the rapid and unexpected growth in the money supply in January, should the Desk have sought firmer money market conditions? Our answer was no. First, the January experience might yet turn out to be only a statistical aberration. It was influenced by an unexplained bulge at the end of December that was slow to disappear. Second, the projections indicated that

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

some--though not all--of the bulge would be eliminated in successive months. Third, the credit proxy continued to show declines, both in January and for the quarter, and it was a shade weaker than had been projected. While there was, as we saw it, no need to tighten money market conditions, there was equally no need for easing. In our view the unexpected strength in money supply for January and--to a lesser degree--for the first quarter roughly offset the continued and expected weakness in the credit proxy; money market conditions were thus kept approximately unchanged, roughly remaining within the ranges specified in the last blue book for alternative A of the directive.

Looking to the period ahead, there may be a number of problems in interpreting the directive.1/ While the directive cannot be interpreted properly before the Committee go-around, it might be useful to review with the Committee the approach I would plan to take unless the Committee has other instructions. First, on the assumption that the Committee adopts alternative A, I would assume that the members would not be disturbed by the 2-1/2 per cent rate of decline in the money supply now projected for February, in light of the January strength and the projected resumption of growth in March. The rate of growth projected for the first quarter is now about double the 2 per cent growth rate the Committee had in mind at the time of the last meeting, but I presume that the continued weakness of the credit proxy represents a sufficient offset. In fact, with the proxy expected to decline in the first quarter by about as much as money supply is expected to increase, there is a question of whether the over-all performance of the aggregates (assuming that the projections are borne out by actual developments) meets the Committee's desires. Should roughly equal weights be assigned each of the two measures or, in light of the distortions that Regulation Q is still causing the proxy, does the Committee want to assign greater weight to the money supply?

While I have no quarrel with the projections, I wonder whether they take sufficiently into account the change in expectations about interest rates that is currently gripping the markets. If these expectations are sustained, there could be a substantial increase in the demand for

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

bank credit from dealers and speculators who try to build up portfolios in order to profit from the turnaround in rate movements while there is a substantial inducement for banks themselves to add to their investment portfolios of Governments and municipals. Since Regulation Q is still an inhibiting factor as far as large CD's are concerned, any such expansion of bank credit would have to find its counterpart in increased exploitation by the banks of the Euro-dollar or the commercial paper markets and developments in these markets will bear careful watching. At some point in time, if the economy continues weak and there are no other upsetting developments, market rates may fall to a level where banks can again find CD money, beginning in the longer maturities. A large-scale resumption of intermediation by the banks would have a pronounced effect on the ability of banks to expand credit--tempered, of course, by the strength of their desire to pay down Euro-dollar or other borrowings and by the strength of loan demand. While I am not suggesting that we are on the verge of an expansion of bank credit such as occurred in the summer of 1968, the possibility of a vigorous rise lurks somewhere in the future, and the Committee should give some consideration as to whether and by how much it would like to resist an expansion of bank credit related to a resumption of bank intermediation.

As I interpret it, alternative B of the directive drafts would reflect a decision by the Committee that--in light of the weakness of the economy and the current and projected rates of growth of the monetary and credit aggregates--an easing of money market conditions is required in order to stimulate greater growth in the aggregates. Money market conditions should be eased now, and if the resulting response of the aggregates turns out greater than the Committee desires, the Desk would be expected to tighten them up again. Alternative A could lead in the same general direction--that is, towards less firm money market conditions--but only if growth of the aggregates over time appears to be weaker than the Committee desires.

Both proposed directives include a clause relating to possible regulatory changes. I would interpret this clause to mean that if the Board decides to bring commercial paper under Regulation D, the resulting increase in reserve requirements should not be allowed to automatically put the banking system under increased pressure but should be offset by appropriate open market operations.

Mr. Mitchell expressed the view that it would be desirable for the Committee to focus on private demand deposits or the money

supply rather than on bank credit, since the Regulation Q ceilings were likely to prevent any near-term growth in the latter. And perhaps it should focus on the growth rate of money in February and March rather than in the first quarter as a whole on the ground that, as Mr. Holmes had suggested, the January surge was likely to prove to be a statistical aberration. He noted in that connection that by the first week of February the money supply had already fallen to a level below its December average. He then asked what money market conditions might be consistent with a 2 to 3 per cent annual rate of growth in money in February and March.

In reply, Mr. Holmes said the New York Bank's projections suggested that the money market conditions now prevailing were likely to be consistent with such growth in the money supply. According to the Board staff's projections some easing of money market conditions would be required, with the Federal funds rate perhaps in an 8-1/2 to 9 per cent range.

Mr. Daane referred to Mr. Holmes' comment that hopes for an early easing of monetary policy based on various public statements had contributed to the recent declines in interest rates. He asked, first, whether a reversal of those declines was likely if the System did not provide early evidence of a more flexible policy stance; and secondly, whether evidence of some slight relaxation of policy was likely to produce an over-reaction in the market and lead to further marked declines in interest rates.

Mr. Holmes replied that the public statements had been followed by relatively sharp rate declines, and rates might well back up if there was no early evidence of a change in policy. However, market expectations of easing were based in good part on the signs that the economy was weakening. On that ground easing was expected relatively soon, but not necessarily immediately.

On the second question, Mr. Holmes continued, the market might well exaggerate the significance of actual indications of easing, particularly if they included large increases in the money supply. In that connection, he noted that a relaxation of policy had been discounted to some extent, but not completely.

Mr. Hickman referred to Mr. Mitchell's comment that the Regulation Q ceilings were likely to prevent near-term growth in bank credit. He noted that the staff had indicated in the blue book that, if the three-month bill rate fell below 7 per cent, banks might be in a position to regain a substantial amount of CD's under current rate ceilings, and that the adjusted bank credit proxy might then expand at a 3 to 6 per cent annual rate in March. He agreed with that analysis and thought it would be appropriate to seek such an outcome.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 15 through February 9, 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. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts and tables have been placed in the files of the Committee.

Mr. Partee made the following introductory statement:

> This is the time of the year when the staff traditionally presents to the Committee its view of the economic and financial outlook for the year ahead, taking into account the fiscal program laid out in the Administration's budget and assuming a particular course for monetary policy. This is our second intensive look at economic prospects for 1970. Fortunately, we are now promised a considerably more restrictive fiscal policy than we had anticipated last October, when we made our first 1970 GNP projection. Also, the incoming economic information since then has been even weaker, on balance, than we had suggested it might be.
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> Indeed, some of the advance indicators of economic performance have turned so sour that predictions of present and impending recession are now quite commonly heard. For this reason, it seems unusually important today to begin by reviewing recent economic developments with a view to assessing their cyclical properties.

Mr. Gramley than made the following comments on recent economic developments:

> Broad measures of economic performance indicate that a significant economic adjustment is now in process. Industrial production--off about another 1/2 per cent in January--has declined at about a 5 per cent annual rate since July, with consumer goods, defense products, and materials output exhibiting appreciable weakness. Only a small part of this decline is attributable to strikes. Retail sales in current dollars have grown slowly since last spring, even though price increases have continued unabated. The latest revisions, for November and December, were downward. In real terms, retail sales have declined to levels below those of a year earlier.
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> Reflecting the slowdown in sales and production, increases in nonagricultural employment have diminished progressively over the course of the year. Along with the reduced pace of employment, average weekly hours

in manufacturing declined over the course of last year, and fell substantially further in January, as overtime work was reduced quite sharply.

The chief weakness since midyear has been in the markets for consumer durables. Expenditures for durables began to decline in the third quarter, as growth in wages and salaries moderated, inflation eroded the real value of liquid assets, and consumers apparently became increasingly apprehensive about the economic and financial outlook. This downturn in expenditures was not anticipated by businesses, and it led to a sizable build-up of inventories. Consequently, output of durable goods has fallen--very sharply in autos, where output last month was down to the lowest level for any January since 1962.

The weakness in consumer durables, together with declines in defense orders, have given rise to a substantial increase in the ratio of inventories to unfilled orders in durables manufacturing. Past periods of recession or inventory adjustment have often been signalled by a rise in this ratio. The recent increase in this ratio has been substantial, and would have been larger but for the G.E. strike. While the current inventory-order relation may not be indicative of impending recession, it clearly does suggest further cutbacks in output in the months ahead.

Production adjustments in consumer durables, in defense products, and in construction already have led to a substantial easing in the labor market. One of the more sensitive indicators of labor market conditions is the weekly average of initial claims for unemployment insurance. These claims have been trending up since the second quarter of last year. This recent uptrend has been similar to those occurring just prior to the recessions of 1957-58 and 1960-61, as well as the mini-recession of 1967. The current level of these claims is still not unusually high, but the upsurge last month might prove to be the first in a series of sizable increases.

Concerns about the prospects for recession stem not only from the behavior of the more traditional cyclical indicators, but also from the increasing tightness of financial markets. Interest rates rocketed upward throughout all of last year; on 3-month Treasury bills, for example, yields in December 1969 were two percentage points above the year-earlier level. Of particular significance is the fact that interest rate increases since the middle of 1969 cannot readily be explained by changes in credit demands. Rather, they seem to have resulted primarily from the severe constraints on supplies of credit from banks and nonbank financial institutions.

Measured in terms of almost any of the major monetary aggregates, monetary policy was unusually restrictive in the second half of 1969. Bank reserves fell sharply in the summer months, when the decline in commercial bank time deposits was steep, and the recovery in bank reserves in the latter months of 1969 left the December total below the midyear level.

The money stock showed almost no growth in the final six months. Growth in bank credit in the second half of the year, even including all nondeposit sources of funds, diminished further to less than a 3 per cent annual rate.

Housing and State and local construction seem to have absorbed the brunt of the effects of this restraint on the growth of the monetary aggregates. But the general rise in interest rates and the constriction in bank credit availability suggest that other sectors may also have been affected. And the sharp drop in stock prices certainly has influenced expectations, and may have been an important source of the sluggish consumer spending we have been seeing.

However, there is also some evidence of continued strength in the near term. Not all of the important advance indicators of economic activity are pointing so clearly downward. Manufacturers' new orders for durable goods, for example, have yet to exhibit the weaknesses that usually characterize the onset of recession. Though new orders have decreased for several successive months, the quarterly average has not yet evidenced the sharp sustained decline that often precedes a recession or period of inventory adjustment. To a significant degree, total new orders have been maintained recently by continuing strength in orders for machinery and equipment.

With backlogs of unfilled orders for machinery and equipment still relatively large, plans for plant and equipment outlays reported in the recent Commerce-SEC anticipations survey may come close to being realized in the first half of this year--although the quarterly pattern may have less variation than the survey results. Inflationary expectations are still persistent and rising wage rates are a continuing stimulus for cost-cutting investments. The structure of planned investment outlays in the first half also argues for near-term strength in this sector. The public utility and communications industries, where capacity utilization rates are high, are the principal industries planning substantial increases.

As the year progresses, investment programs may be stretched out or cut back in cyclically sensitive industries. But the near-term outlook still suggests enough strength to avert a significant downturn in plant and equipment spending.

On the fiscal side, the budget is becoming more stimulative during the first half of the year, mainly because of the reduction in the surcharge and the second-quarter increase in Social Security payments. This will raise disposable income and consumer spending power at the time when economic weaknesses are likely to be the greatest. Some pick-up in consumer spending is essential if recession is to be averted, and these special income supplements provide hope of achieving it. Later in the year, the budget provides somewhat less stimulus--but most forecasters are expecting increased strength in private spending by that time.

Our own staff estimates of GNP growth and Treasury revenues are below those of the Administration, and hence we think the deficit could be somewhat larger than that projected in the Budget. These differences in estimates of the surplus or deficit stem entirely from our more pessimistic views on the GNP outlook.

Given the amount of fiscal stimulus expected in the first half--by either measure--together with the probable near-term strength of business fixed investment, we believe it is still possible to avert a recession. Some cumulative downward tendencies seem to be developing in the first half of this year, but these are likely to be limited by fiscal stimulants and rising business capital spending.

To develop our projection of GNP, we have assumed a course of monetary policy that we judge would work against unduly large reductions in output, and provide for a resumption of economic expansion later in the year. At the same time, the stance of policy assumed would, we believe, encourage progress towards controlling inflation. Expressed in terms of bank reserves, we assume a return to an annual growth rate in the 2-1/2 to 3 per cent range in the second quarter, and to a little more than a 4 per cent annual rate in the second half. Our current short-term projections suggest, however, that a decline may occur in February and possibly in March.

The money stock consistent with this reserve projection would grow at about a 3 per cent annual rate from February through the second quarter and at about a 4 per cent rate thereafter.

Renewed growth in reserves and the money supply would also lay the basis for an improvement in the flows of savings and time deposits to commercial banks and the non-bank intermediaries. Financial institutions, therefore, would be able to play a more active role in supplying credit needs than they have in recent months.

Mr. Wernick then presented the following review of the staff's GNP projection:

The review of our GNP projection begins with a consideration of the major new piece of information that has become available this year--the President's Budget. The central feature is a tight control over Government expenditures, highlighted by a projected drop of $7 billion in defense outlays over the course of 1970. This drop reflects both reduced purchases of goods and a cut of close to one-half million men in the Armed Forces. Last year, in contrast, defense outlays remained relatively stable.

Other Federal expenditures on a national income accounts basis--including transfer payments, grants-in-aid and nondefense purchases--are expected to rise sharply through the first half of the year, largely in response to the second-quarter boost in Social Security benefits, which includes retroactive payments. In the latter half of the year, however, these expenditures level off as the bulge in transfer payments recedes and other outlays are under a taut rein.

The over-all growth in total Federal expenditures, reflecting these offsets, is thus quite small--an increase of only $5 billion from the fourth quarter of 1969 to the fourth quarter of 1970. This is substantially less than the growth last year.

Our own projections of receipts, meanwhile, are somewhat lower than the official estimates, because we foresee a somewhat smaller rise in GNP and less income and profits than indicated in the Administration's projections.

Consequently, we expect the budget to move significantly into deficit in the second quarter, when Social Security payments increase. The deficit should stay at about the same level in the third quarter, when the surcharge is removed, but then may diminish somewhat in the fourth quarter, as receipts improve with the pickup in GNP.

Our GNP outlook for 1970 is somewhat more bearish than that of the Council, mainly because we expect a somewhat larger reduction in inventory investment from the peak in the third quarter of 1969. Production cuts in response to excess inventories have already begun, but ratios of inventories to sales and unfilled orders are high and rising, and further cuts in output are probable. Also, the expected declines in defense purchases seem

very likely to bring a reversal in the four-year run-up of defense inventories.

While we are projecting a further decline in inventory investment, we expect the reduction to be moderate compared with the adjustments after the peaks in the fourth quarter of 1966 and the third quarter of 1957. Our anticipation of only a moderate adjustment this year has been influenced by expectations of near-term strength in business fixed investment, the likely pick-up in consumer spending this spring, and the bullish view of the longer-term prospects apparently held by most businessmen.

In the consumer sector, there are conflicting factors in the outlook. Consumer attitudes have deteriorated, apparently in reaction to rising prices and concern about future income and employment. In the sluggish economic environment we are projecting, a sharp rebound of consumer confidence and spending seems unlikely. On the other hand, some rise in the growth rate of consumer expenditures from the recent pace seems probable, particularly in the second and third quarters, because of the large increases in Social Security benefits and the elimination of the surcharge, which add substantially to disposable income. The gains in spending should be relatively moderate, however, because of a slowing in the rise of wage and salary income.

We also expect that consumer spending will not respond fully to the increases in disposable income early this year. Some of the gains from lower taxes and other income supplements seem likely to be added to savings, so that the saving rate should drift up a little.

For business fixed investment, we are projecting about an 8 per cent gain, year-over-year--somewhat less than suggested in the most recent Commerce-SEC survey. While further increases in these outlays do seem probable in the first two quarters of this year, lower profits and excess capacity should be conducive to a leveling out of spending later in the year.

Recent trends in the value of new orders for machinery and equipment and in the physical output of business equipment appear consistent with this investment outlook. Unfilled orders have remained high enough to support some further increase in outlays in the near term. But the flattening out in the trend of new orders, with recent months down sharply from earlier peaks, suggests that investment outlays may be approaching a crest.

For housing, the intra-year pattern is likely to be the reverse. Drains on savings at nonbank depositary institutions were very large in January and the availability of private mortgage funds has been sharply curtailed. Continuing assistance to mortgage markets from FNMA and the Federal Home Loan Banks is providing important support to housing starts, but a fall in starts to an annual rate of just over one million units in the second quarter seems highly probable. Subsequently, there should be a recovery in starts if the assumed easing in monetary policy occurs and savings inflows are resumed.

A similar decline and recovery, though less abrupt, may occur in State and local construction outlays. During 1969, high interest rates and financing difficulties curtailed these expenditures, and they are projected to drop further in the first part of 1970. But these outlays, too, should begin to pick up later in the year as funds become more readily available.

Summing up these major sectors of spending, we project GNP growth to slow further, to about $7 billion in the first quarter, and then to increase a bit in the second quarter as consumer buying improves. Increases in GNP could then resume at a more rapid pace after midyear, if the inventory correction has run its course and financing conditions permit a pick up in housing and State and local construction.

In real terms, our projection implies a decline in GNP at an annual rate of about 1-1/2 per cent in the first quarter and no real growth in the second. Even though real GNP growth is projected to resume after midyear, the gains seem likely to remain well below the potential growth in labor and capital resources.

Translated into industrial production, our projection implies a further decline through the second quarter of 1970, at about the same rate we have been seeing since last summer's peak. Although production is expected to rise moderately later in the year, the index at the end of 1970 is still likely to be below the fourth-quarter 1969 level.

With industrial production weak and additions to capacity continuing relatively large, the rate of capacity use is projected to decline substantially this year. The emergence of excess capacity should increasingly impinge on the ability of businesses to pass increased costs through to higher prices.

Our projection also implies a marked further easing in the labor market--with only small increases in total

employment in both halves of this year. In some sectors, such as services and State and local governments, employment gains may continue to be large. But industrial employment is projected to decline further through next summer. Productivity gains--which are expected to improve as output rises in the second half--should act to limit employment gains later in the year.

As pressure on manpower abates, the labor force should grow more slowly. But because of the scheduled sharp reduction in the Armed Forces, the civilian labor force is projected to rise about 1.7 million in 1970--only a little slower than in the last half of 1969.

Consequently, unemployment is projected to rise rather steadily throughout 1970, with the over-all unemployment rate moving up to 4-1/2 per cent by mid-year and to 5 per cent before year end.

As unemployment rises, product markets soften, and profits fall, the relative bargaining position of workers is apt to weaken, and employers' resistance to large pay increases should intensify. Nonetheless, we still anticipate a substantial rise in compensation per manhour this year, as workers strive to make up for the erosion of real earnings caused by inflation. Wage increases in new contracts will be large, and will only be partly offset by reductions in overtime and other premium payments. Consequently, any slowing in the rise in average hourly compensation probably will be very modest.

Since productivity gains typically improve as economic growth resumes, we have projected greater growth in productivity during the last half of the year. Mainly for this reason, the increase in unit labor costs would slow--perhaps to about a 3-1/2 per cent rate in the last quarter of the year from over a 6 per cent rate this past quarter. An important cost pressure would thus be diminishing and the outlook for reducing the rate of inflation would improve as the year progresses.

In the near term, however, labor and other costs are likely to continue their upward momentum and prices to rise at a rapid pace. Reduced demand for consumer durable goods, defense products and materials should eventually take some of the steam out of price increases for industrial products, but we will have to wait a while for these results to show up. The recent surge in prices of farm and food products, in part reflecting adverse winter weather, should also moderate, if the anticipated increase in supply of vegetables and meats in the spring materializes. We thus see a slackening in the rise in the wholesale price index in the late spring or early summer.

The near-term outlook for consumer prices is also gloomy. But an easing in wholesale prices should eventually be reflected in a moderation in prices of both foods and nonfood commodities. The cost of services, which account for one-third of the CPI, is likely to continue its inexorable rise, but there is some hope, if mortgage interest rates stabilize, that even the increase in service prices may slow somewhat later in the year.

Mr. Hersey then presented the following statement on international developments and the U.S. balance of payments:

We shall first give some attention to developments abroad. This year two questions are of special interest. First, what are the chances that economic conditions abroad may reinforce recessionary tendencies in this country? Second, how will interest rates abroad behave in relation to ours?

Last summer and early autumn, just when our industrial production was leveling off, there was a marked, but temporary, slackening in the rise of Western European industrial output. This followed twelve months of very rapid expansion, and it bore some of the signs of an inventory adjustment process. Both in Germany and in Britain, additions to inventories were large early in 1969. In France, too, though comprehensive quarterly estimates do not exist, inventories may well have been built up in anticipation of a devaluation and accompanying price inflation. Subsequent declines in output were most marked in the textile industries of all three countries. An important special factor limiting output in Italy was a wave of strikes from September through December.

The underlying strength of demand in continental European countries last summer is illustrated by the continuing buildup of orders for German machinery and equipment in excess of current sales or deliveries. Export orders rose very sharply until the revaluation of the mark, and even in October and November they remained quite high. Domestic deliveries of capital goods rose particularly sharply in October, but even in that month order backlogs were apparently still being built up. In Britain, too, a very large buildup of export order backlogs for capital goods occurred in the first half of 1969, while domestic orders and deliveries fluctuated around a level trend--illustrating rather well the readjustment that has been going on in the British economy as resources are shifted toward exports.

The intensity of the German boom is shown by the extraordinary excess of job vacancies over unemployment. With big increases in wage rates enlarging the expansion of personal income, the German economy is now in transition from an export-led investment boom to a consumption boom. In Britain, the degree of slack in the labor market that developed in 1966 has not been significantly reduced. With an election coming, and also in view of the improvement in the U.K. balance of payments, it is generally expected that restrictions on consumption may be eased before long. But despite the labor market slack, a wave of substantial wage increases began late last year and will be continuing this year.

Our conclusion from the available information is that strong further expansion in Western European economic activity is likely. We think there may be a rise of about 6 per cent in over-all industrial production from the second half of 1969 to the second half of 1970. GNP growth may be a little less than that in real terms, but perhaps in the 8 to 10 per cent range in money terms--with some countries higher and some lower. Developments in Germany will be of crucial importance. Given present conditions and prospective Governmental policies, we do not now expect anything like the German recession of 1966-67. On the contrary, we look for maintenance of fairly steady growth.

Turning now to the question of interest rates, we note that monetary policy is playing a key role in most countries in the effort to check excessive demand, and with support from fiscal policy. Central bank discount rates are high, and market rates in recent months have gone even higher, especially in Germany. The massive outflow of foreign speculative funds from Germany since October, on top of a basic balance of payments deficit, has reduced German bank liquidity considerably, though the impact was partly absorbed by a cut in bank reserve requirements last November. In Britain and France mandatory bank credit ceilings have been important policy instruments, backed up in Britain by fiscal, debt management, and open market operation policies severely limiting the supply of Treasury bills for bank liquid assets.

Nevertheless, European interest rates would probably not have risen so much had it not been for the pull exerted by steeply rising Euro-dollar rates in the first half of 1969. If U.S. banking conditions were to push Euro-dollar rates down further, from the present 9-1/2 per cent level toward something like the 8 per cent level of a year ago, it is possible that European central banks might allow their rates to decline.

A year ago, when German interest rates were relatively low, the large forward premium for the German mark restrained interest-sensitive movements of short-term funds out of Germany except when the German central bank provided cheaper forward cover. Such movements out of sterling, then at a large forward discount, would have been profitable, but were effectively restrained by Britain's exchange controls. Now forward discounts and premiums have shrunk, and interest rates are more closely aligned with the 9-1/2 per cent Euro-dollar rate. However, to the cost of Euro-dollars for major U.S. banks must now be added the marginal reserve requirement. Any strong tendency toward lower rates here could be transmitted to other markets through repayments by U.S. banks to their branches and movements of funds out of the Euro-dollar market toward continental European banking systems and the British sterling money market. How much of an outflow of funds from the United States would be entailed in this process would depend on interest rate policies of the European central banks.

In any consideration of the U.S. balance of payments outlook, one of the biggest questions is the size of the run-off that may occur in the liabilities of U.S. banks to their branches abroad. As individual banks move back toward their May 1969 levels, the desire to avoid automatic reduction of reserve-free bases under Regulation M may prove helpful in safeguarding the U.S. reserve position.

Nevertheless, if our economy weakens in the first half, as projected, and monetary policy follows the course assumed, substantial net repayments of Euro-dollar borrowings by U.S. banks during 1970 are likely. This means that the range of possibilities for the overall balance of payments deficit on the official reserve transactions basis is deeper--as well as wider--than the $3 billion to $5 billion range of probabilities now seen for the liquidity balance with or without adjustment for special Government transactions.

The moderate improvement that we expect in the adjusted liquidity balance--from a deficit over $5 billion in 1969 to a middle-of-range projection of $4 billion in 1970--would result primarily from an improvement of about $1-1/2 billion in the goods and services balance. Last year's abnormally large unrecorded outflows into Euro-dollars and German marks would not be repeated, so that "errors and omissions" would be back to a more normal amount; but other movements of private capital, U.S. and foreign--quite apart from the possible run-off of foreign liquid balances in this country--would on the whole be more unfavorable than in 1969. This would reflect primarily smaller net inflows of foreign direct

investments in the United States, commercial credits, downpayments for aircraft, and the like.

Foreign net purchases of U.S. corporate stocks, which fell off last year, may rise again later in 1970, but the year's total is not likely to exceed last year's. Similarly, sales of bonds and other long-term borrowings by U.S. corporations abroad, which became very large when the compulsory Office of Foreign Direct Investment rules started in 1968, may be no larger in 1970 than in 1969, especially in view of the tightening in the German capital market. On the other side of the accounts, we expect a considerable increase in outflows for U.S. direct investment abroad, largely offset by decreases in outflows for foreign securities and bank credits.

The projected rise in net exports of goods and services from about $2 billion on average in 1969 to over $3-1/2 billion this year assumes a moderate reduction in the level of interest payments by midyear but reflects mainly a rise in the merchandise trade balance. The projected fluctuation between half years does not represent a trend-cycle reversal, but is due to special circumstances for aircraft exports.

After the first rush to fill orders for jumbo jets, a pause in aircraft shipments is expected after midyear. Agricultural exports may fall off slightly from recent levels. Automotive component shipments to Canada may rise. All other exports, approaching a $30 billion rate by year end, have been projected by an interagency group as increasing only about 4 per cent from the second half of 1969 to the second half of 1970. Perhaps this is too pessimistic, considering the strong demand expected in Europe and Japan; however, most of our exports to Canada will probably be weak.

On the import side, expansion should be negligible for most of the year. In value terms, imports will rise less than GNP from the fourth quarter of 1969 to the fourth quarter of 1970. This is the first time that that has happened since the latter part of 1966 and first three quarters of 1967. Incidentally, the fluctuations in the first two quarters of 1969 are due to the port strike.

Much less of a dip in imports of industrial materials and fuels is projected for this year than occurred in 1967. As at that time, there may be a slowing in the rise of imports of finished manufactures other than Canadian autos. In fact, such imports were already down a little in the fourth quarter, after nearly doubling in value over 3-1/2 years and quadrupling over a decade.

Looking further ahead, a resumption of rapid growth in U S. imports of finished manufactures, coming as it may when growth in our export markets may be less rapid than of late, could put a serious burden on our balance of payments unless adequate adjustments are made in international cost and price relationships.

Mr. Partee concluded the presentation with the following comments:

Our GNP prognosis for 1970 suggests that we will be undergoing a period of substantial economic weakness during at least the first half of this year. Whether the adjustment now in process will ultimately be characterized as a recession is uncertain. We do expect to see some of the cumulative downward tendencies characteristic of earlier recessions, but we think they will be cut short by fiscal stimulants and the near-term strength of business capital spending. And if monetary policy follows the course assumed, we would expect a strengthening of other demands as the year progresses.

Whatever the current adjustment and subsequent rebound is called, monetary policy in the months ahead will have to tread a narrow path. Continuation of too much restraint now would add fuel to any cumulative downward tendencies in process; too abrupt or too large a move toward ease could put off indefinitely the needed reduction of inflationary pressures by encouraging resumption of an inordinately rapid rate of economic expansion late in 1970 or in 1971. The progress we can realistically expect in getting inflation under control in 1970 is, in any case, distressingly small; our projected GNP deflator is still rising at a 3.5 per cent annual rate in the fourth quarter of the year.

Given the inherent uncertainties in the present situation, we need to consider carefully the possibilities for a different pattern of economic responses than now projected.

Personally, I am not so sure that businesses will be willing to continue investing in inventories at the rate we have assumed. The projected decline is mild--the rate of investment never turns negative, as often happens in periods of inventory adjustment. Our econometric model, which reflects past relationships, shows a somewhat deeper dip--though the rate of investment remains above zero. The staff has opted judgmentally for the higher path mainly because business price and

sales expectations for the longer run still seem quite strong. But if a spring pickup in consumer buying does not materialize, these expectations would be shaken and there could well be a retrenchment in desired inventory levels.

For business fixed investment, also, the risks seem to run towards overprediction. The projected increase in expenditures would occur despite a peak-to-trough decline in total corporate profits of nearly 10 per cent, which would imply a considerably larger earnings drop in manufacturing, where the capacity utilization rate declines substantially. Such investment behavior can be rationalized only in the context of continued inflationary expectations. If significant recession should become a fact rather than a threat, however, I have little doubt that present plans would give way to cancellations and stretchouts.

Looking to areas where our projections may underestimate underlying strengths, consumer expenditures come to mind most prominently. We assume a continuation of relatively pessimistic consumer attitudes, so that the large additions to disposable income stemming from Federal Government transfers and the tax reduction do not carry through fully to spending; part of the increase in incomes goes into higher savings.

Consumer attitudes are volatile, as we all know. It would seem prudent to assume that if a significant shift in spending propensities were to occur, it would be towards greater ebullience in consumer buying.

Prudence would also seem to dictate expectations that fiscal stimulus might turn out to be somewhat greater than projected. The budget for fiscal 1971 entails extremely tight controls over expenditures, together with the legislative actions necessary to achieve decreases in some programs and moderately larger tax revenues. The Administration clearly is prepared to do what it can to obtain budget restraint, but a high order of Congressional discipline will also be required. Budgets often turn out to be more stimulative ex post than they seem ex ante, and the odds would seem to lean in this direction once again.

It was with these uncertainties in mind that the staff chose, as a set of working assumptions, the course of monetary policy underlying our GNP projection. The assumed growth rates of bank reserves and the money stock, which are in the 3 to 4 per cent range, do not imply a shift to highly expansive monetary policies.

Indeed, the assumed rates of growth are no more than those needed to sustain normal expansion in current-dollar GNP over the longer run.

In deciding whether the growth rates assumed here are appropriate for policy, the Committee will need to consider mainly whether its views on the economic outlook agree with those of the staff. However, account also should be taken of the relatively strong demands for credit likely to be present this year, even if the GNP increase remains moderate.

During 1969, nonfinancial corporations raised enormous sums in the credit markets, because the shortfall between gross retained earnings and outlays for fixed capital and inventories increased substantially. Gross retained earnings last year were only 3 per cent above 1966, but total capital expenditures were up 12 per cent over the same period.

Next year, the margin is projected to widen further; gross retained earnings are expected to change little--as the continuing rise in capital consumption allowances is offset by a decline in undistributed profits--while capital expenditures are projected to rise further. The amount to be financed externally is extraordinarily large.

Funds raised by nonfinancial businesses in 1970, therefore, should be every bit as large as they were last year. The demand for funds will probably be concentrated in long-term security issues, since corporate liquidity has deteriorated this past year with the rapid run-up of short-term debt.

The Federal Government, moreover, will return to the position of a net borrower during this calendar year, according to our revenue projections. This is in contrast to 1969, when the Treasury repaid debt.

For households and other private borrowers, on the other hand, funds raised this year probably will be less than in 1969--partly because growth in demands for consumer credit will subside with relatively slow expansion in durable goods sales, but mainly because of the lagged effects of monetary restraint on housing and the growth of mortgage credit. Taking Federal borrowing and all private sector borrowing together, however, we believe that the total this year could well be above 1969.

Given this degree of strength in credit demands, and the assumed additions to bank reserves and the money supply, there would be room for only moderate declines in interest rates this year.

For 3-month Treasury bill rates, results from our econometric models support our judgmental estimates of a fall to a range of 6-1/2 to 6-3/4 per cent by midyear. There would be little change in the second half, as the moderately higher rates of growth of reserves and money assumed for that period are accompanied by a projected pickup in the tempo of economic activity and hence in transactions demand for money.

For long-term rates, strong expectational reactions to any easing of monetary policy could be expected initially, but the strength of demands for long-term funds by corporations and by State and local governments should limit the extent of downward adjustment. Our projected ranges are rough estimates of the changes consistent with the projected drop in bill rates--given the supply situation in long-term markets.

While the projected interest rate adjustments are not large, they would be of great significance for the ability of banks and other depositary institutions to bid for funds. For example, last Friday's yield curve on Treasury issues--with bills calculated on an investment basis--was still well above the maximum rates banks can pay on CD's. If the yield curve were to shift downward by about the amount we project, however, CD's would once again become a viable instrument. Bank sales of shorter-term CD's would still be limited by stiff competition from bills and other market instruments, but there would be more freedom to bid for funds in the over-one-year range. As a rough approximation, we might expect outstanding CD's to increase at $600 to $800 million per month.

At commercial banks, the total of time deposits less CD's would also be expected to respond to the projected decline in market interest rates. Such inflows might have recovered to an annual rate of about 7 per cent by the second half. With CD's also rising, total time deposits at commercial banks by year-end 1970 would return to about the level at the end of 1968.

For nonbank intermediaries, the effect on deposit flows of high market interest rates last year was not as great as for banks, and the projected response in 1970 is also milder. But by the latter half of the year, deposits at these institutions might be rising at around a 6 per cent annual rate--about the same as in the latter part of 1968.

These projected deposit flows would permit the growth rate of bank credit to increase from the unusually low pace in 1969. The projected average rate of increase for the first

half of 1970 would only be about 4 per cent, since growth from March through June would be offset in part by the steep January decline and a probable further drop in February. By the second half of the year, growth in bank credit would pick up to about a 7 per cent annual rate--still well below the high rates of 1967 and 1968.

The bank credit figures used here include changes in all nondepositary sources of funds. Along with the deposit changes already discussed, the projections assume some decline in Euro-dollar liabilities and a marked slowing of the rise in commercial paper issued by bank affiliates--following the recent upsurge.

If the Committee wishes to move immediately to a course of policy broadly in agreement with that assumed in the staff GNP projection, directive alternative B would seem to be closest to the spirit of our assumptions. As the blue book indicated, the specifications for B call for a Federal funds rate falling to the 7-1/2 to 8-1/2 per cent range, and net borrowed reserves in the range of $550 to $750 million.

With these money market conditions, growth in the money supply probably would be in the 4 to 5 per cent range in the first quarter--a figure higher than assumed for the longer run, but only because of the huge run-up in demand deposits around the year end. The adjusted credit proxy would probably show little net change for the first quarter as a whole, given the decline that has already occurred. But it might rise considerably in March, as market interest rates dropped to levels that would permit banks to attract CD's in some volume.

If the Committee wishes to delay movement toward less restraint, or to adopt a more stringent course of policy than we have assumed, alternative A would be more appropriate. This would imply maintenance of the Federal funds rate and net borrowed reserves at close to recent levels.

Under these conditions, we would expect the money supply to show a growth rate in the 3 to 4 per cent range in the first quarter--again largely reflecting the run-up of demand deposits at the turn of the year. But the adjusted credit proxy under this alternative would probably stay negative, reflecting a continued weak performance for time deposits.

What is most important, in my view, is that policy seek to achieve some moderate growth in the money and banking aggregates, now that the economy's upward momentum is spent and a downturn of some proportions seems to be in process. In particular, any weakening tendency in the aggregates must be strongly resisted in order to

avoid a repetition of past cyclical experience, when the demand for money and credit has often tended to fall and there has been unintentional contraction in monetary aggregates. This minimum strategy already appears to be embodied in the current policy directive and repeated in alternative A today. Whether the Committee chooses to move now or a little later on to restore a more normal monetary growth rate, as envisioned by alternative B, seems to me a less crucial matter. But there is little risk left in a moderate easing of policy now, given the apparent deflating trend in expectations, and we would need to move fairly soon in any event if a second-half recovery in housing and State-local capital spending is to be achieved.

Chairman Burns commended the staff for its excellent presentation.

In reply to a question by Mr. Mitchell, Mr. Partee said he thought bank sales of CD's were likely to resume first for certificates with maturities of over one year, where the 7-1/2 per cent ceiling rate was much closer to current market yields. If the staff's assumptions were correct, shorter-term yields would not drop enough to make CD's with maturities of under one year fully competitive. Of course, if there were a greater weakening of business or easing of monetary policy than anticipated in the projections, the yield curve could shift more than forecast and shorter-term CD's might also become quite competitive again.

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

Now that real growth in the economy has apparently come to a stop, it is not surprising that more and more arguments are being advanced in favor of relaxing the present degree of monetary restraint. My own judgment

is that such a move at this time would be premature and unwise, in the light of the continuing strength of inflationary tendencies and expectations, the uncertain outlook for effective fiscal restraint, the high probability that the slowdown may be short-lived, and the ambiguous nature of recent trends and current projections of the money and credit aggregates.

The major new development since our last meeting has been, of course, the release of the Administration's budget and economic reports. I think we must recognize that very strenuous efforts were made by the Administration to keep the amount of Federal spending under severe restraint. Of course, a considerably larger surplus would have made our task much easier. But what must give us pause is the very real possibility that the estimate of total expenditures will prove too optimistic. If this does happen, there would seem to be a serious risk that the business slowdown will be aborted, before it can have much effect on prices and wages, by massive Federal injections into the spending stream. Moreover, if misgivings concerning the budget become more widespread, the so-called "other-side-of-the-valley" psychology, already all too prevalent among businessmen, may well be strengthened.

A close analysis of the budget suggests that the projected spending total depends heavily on achievement of large cuts in defense outlays, and since it would appear that Vietnam is clearly the area where the savings are expected to come, this part of the budget must share the uncertainties of the President's program for withdrawal from Vietnam. Achievement of the budget also depends to a large degree on greater spending restraint in Congress than has been evident in recent months. For example, the budget assumes that the next Federal pay increase will be deferred by six months to January 1971 and will be limited to 5-3/4 per cent, whereas Congress has been leaning toward a larger and earlier increase. Another area of concern is that the over-all impact of Federal activities is being obscured to some extent by the shift away from direct lending to the use of guaranteed and insured loans. Such loans are expected to increase by $18 billion in fiscal 1971, double the increase of the current year.

It is hard, indeed, to find much cheering news on the wage and price front. Apart from the cost-of-living clause the General Electric settlement looks rather moderate for these times; but if prices continue to rise fairly rapidly, as seems not unlikely, the contract could prove perhaps as expensive as the typical contract negotiated in 1969. The outlook for major negotiations in 1970 is disturbing. On the basis of my own talks with

businessmen, I see little evidence that they have altered their view that inflation is likely to continue at a pretty rapid pace over the coming year or two.

The sharp increase in the unemployment rate for January should not in itself cause either much surprise or much alarm. I think we have all recognized that the very low rates of November and December were something of an aberration, and that the rate was bound to respond in due course to the slowdown in the economy. Most other employment statistics have, of course, been pointing for some time in the direction of less tight labor markets. But we should retain our sense of perspective and bear in mind that over-all unemployment rates under 4 per cent generally suggest labor shortages in a great many areas; also that some moderate rise in unemployment is a necessary condition to checking the inflationary spiral. This is another way of saying "The slowdown is what we have been trying desperately to achieve. Let's not reverse it before it has had some results."

Turning for a minute to balance of payments considerations, we must face the fact that 1970 is expected to be another year of a large liquidity deficit (though possibly smaller than that of 1969). Furthermore, there is little likelihood that the official settlements balance will be much better, in sharp contrast with the 1969 situation in which heavy Euro-dollar borrowing by American banks produced a sizable surplus. All of this merely underlines the vital importance of success in the anti-inflation effort from the point of view of the dollar's international standing. We should not be misled by the continuing rather calm state of the exchange markets, which merely means that our problems in this area are long-range rather than immediate.

Perhaps the most popular argument in favor of some loosening of the monetary reins is that the money and credit aggregates must be allowed to resume some reasonable growth after a good many months of virtual stagnation. Setting aside the obvious fact that the rapid inflation has been easily sustained by higher money velocity (doubtless reflecting to some extent the very high rate of nonbank credit extension), a close examination of the money supply figures does not reveal the stagnation that is so often assumed. One market newsletter, for example, suggested last week that the Federal Reserve must be interested in re-establishing monetary growth of 2 to 3 per cent. Yet the latest data I have seen reveal a 2 per cent growth rate in the money supply for the six months through January, a 4-1/4 per cent rate for the three months through January, and a blue book projection under alternative A

of a 3 - 4 per cent rate for the first quarter of 1970. Is this a record that suggests by itself the need for a significant change of policy at this time? Of course I realize that the data on bank credit have been relatively sluggish, mainly because of disintermediation induced by Regulation Q. There is no doubt that the money supply receives a great deal more public attention than the credit data; and it is quite possible that release of the figures showing a very strong growth rate for January will, rightly or wrongly, stimulate new public fears of inflation.

There is another reason why I would be reluctant to take our foot off the brakes at this time. We know that the credit and security markets are poised expectantly, in the light of all the talk and rumors about a possible easing of policy. If expectation of lower interest rates, of the kind we have already seen in the past ten days, should build up further, bank credit might show unexpected strength, as bankers and dealers decided to add to their investments and as bank loans were used to finance dealer inventories. Beyond this, of course, if market rates continue to fall, we might see substantial reintermediation. All of this suggests that, in our current emphasis on the aggregates, we should not lose sight of the importance of interest rates and market psychology in reaching our policy decisions.

I am sure it is clear that I would favor an unchanged open market policy at this time. The wording of alternative A appeals to me, with its clause indicating our interest in modest growth in the aggregates, but with firm money market conditions remaining our principal operating instruction to the Manager. I think the Manager should be given reasonable leeway to use his judgment in interpreting the clause with respect to the aggregates and in implementing the proviso. My own preference would be for a more prompt use of the proviso to check some unexpected strength in the aggregates than to compensate for some shortfall.

With respect to bank-related commercial paper, I think the Board faces some difficult questions as February 26 approaches. One principle that should be adhered to, in my view, is uniform treatment of subsidiary and holding company (or affiliate) paper. Since imposition of Regulation Q ceilings on commercial paper would seem to call for additional raising of these ceilings if too much restraint is to be avoided, the Board might wish to defer any such action; but it would seem reasonable to apply reserve requirements rather promptly to all kinds of bank commercial paper.

Mr. Francis noted that at its meeting on January 15, four weeks ago, the Committee had decided to seek some monetary expansion. Whether it was now actually launched on such an expansion was difficult to say. According to the staff's estimates for the week ending February 4, both the money supply and the demand deposit component were lower than in the week ending January 14, reflecting the elimination of the unusual bulge around year end. It was clear that no significance should be ascribed to that short-term experience. It was neither practical nor important that the money supply move in a particular direction at a particular rate for so short a period as three or four weeks. The important thing was to get movement in the desired direction at approximately the desired rate over a period of several months.

Mr. Francis observed that he favored alternative A for the directive in view of the staff's projection that growth in the money stock was likely to be at about a 3 to 4 per cent annual rate from December to March under that alternative. He trusted that the process of achieving such a growth of money was under way, and he hoped that the Desk would interpret the proviso clause in such a manner as to produce such money stock behavior.

Mr. Francis remarked that under present and likely vagaries of the relation between Regulation Q ceilings and market interest rates, and resulting fluctuations of bank time deposits, he would think it best to forget about bank credit or total member bank deposits as objectives of monetary policy. In any case, he could

not see what significance there was for monetary policy and total spending if funds flowed through the commercial paper market rather than through CD markets.

According to studies at the St. Louis Reserve Bank, Mr. Francis continued, if the Committee did not pursue some significant rate of monetary growth there was very likely to be a quite unacceptable decline of real product and increase of unemployment in the last half of 1970. On the other hand, if monetary growth was at a rate significantly greater than 3 or 4 per cent a year--for example, a 6 per cent rate--there would be little or no reduction of the rate of increase of prices. He would submit for the record the Bank's current estimates along those lines.[1/] Preliminary drafts of the underlying study had been mailed to the Directors of Research at the Board of Governors and at each of the Federal Reserve Banks.

With respect to the recent revision of Regulation Q, Mr. Francis felt that it was a year delayed. Furthermore, the increases allowed in ceiling rates appeared to be too small to be of much help in stopping or rectifying the financial distortions which had resulted from Regulation Q in the last year. He suggested that the Regulation Q ceilings be raised further and that the complicated system of classifying deposits be simplified. Since he believed that Regulation Q had not been an instrument of restraint on total spending and inflation, he also believed that further increases in the ceilings would not be a step stimulating total spending, but rather would

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1/ Appended to this memorandum as Attachment B.

help to restore normal operation to the financial intermediation system.

Mr. Francis suggested that there was another respect, in addition to the interest rate ceilings, in which the System might well put itself into touch with realities. That was with regard to the discount rate. He suggested that the rate should be adjusted in line with market rates. The discount rate was now about 2 percentage points below short-term money market rates, providing quite an irrational differential. Of course, the current low rate was neither stimulative nor restraining; it was without monetary or stabilization significance. But it did mean that when banks borrowed from the Federal Reserve they received a windfall. Under present conditions banks were prevented from unlimited borrowing only by the administration of the window, and there were no rational principles for that administration. He suggested that the System escape from that irrational situation, which only made enemies and created confusion, by raising the discount rate in line with money market realities.

Mr. Kimbrel said that on behalf of all of the people at the Federal Reserve Bank of Atlanta he would like to welcome Chairman Burns into the System.

Mr. Kimbrel then noted that the emerging economic news indicated more and more convincingly that the period was one of economic slowdown. Nevertheless, how severe the slowdown would be or how long it would last remained unanswered questions. Although

the slowdown was readily visible in the Sixth District, a major downturn was not in evidence there. Total nonfarm employment in December showed only a slight decline--less than 1 per cent. In the future the effects of defense cutbacks might become stronger, since the District was more dependent upon defense-related activities than were some other areas of the nation.

Mr. Kimbrel reported that layoffs at Cape Kennedy had depressed the economy of that part of Florida. Cutbacks in production of ordnance had cost several thousand jobs in Huntsville, Alabama; and New Orleans and Gulf Coast employment had felt the depressing effect of a reduction in activity at Mississippi's rocket-testing facilities. Lockheed had already cut employment by over 1,000 in the Atlanta area and further cuts were expected unless C-5A orders could be procured. The dollar volume of announcements of new or expanded manufacturing plants in the District had declined 14 per cent in the final quarter of 1969.

Incidentally, Mr. Kimbrel said, the Sixth District had to take part of the blame for the recent sharp rise in the price indexes. Because earlier freezes in Florida had destroyed plantings, fresh vegetables were now in short supply. Moreover, recent freezes in Florida also had destroyed plantings and would reduce future supply.

Mr. Kimbrel observed that experience during preceding periods of economic softening would lead one to expect an eventual, although not immediate, price response. Two major features, however,

distinguished the present from preceding periods of economic slowdown. The current period of rising prices had lasted longer and might have generated greater expectations for continually rising prices and high interest rates. In addition, a large part of the nation's resources were continuing to be devoted to a major military operation.

Under those circumstances, Mr. Kimbrel remarked, it was especially hard to decide how much of the recent decline in rates in the money and capital markets reflected softening demand for credit rather than a change in expectations that could be soon reversed at the first sign of an excessive easing of credit policy. Thus, making some assessment of the strength of credit demand became especially important at this time.

January loan figures for all Sixth District member banks showed a greater than seasonal decline for the month, Mr. Kimbrel said, with most of the decline at the smaller banks. That reversed the direction of the figures for December, when loans were up substantially. However, bankers at the few large banks contacted saw no slackening in loan demand and expected to see none in the immediate future.

In the municipals market for the District, Mr. Kimbrel continued, there was a substantial backlog of municipal offerings that had not yet come on the market, according to an informal survey conducted by the Atlanta Bank. However, the greater part of the backlog would not enter the market until the latter part

of the year and then only if credit conditions eased or rate ceilings were adjusted. Moreover, some of the long-term financing would be a substitute for existing short-term financing.

Meanwhile, Mr. Kimbrel said, during January District banks had experienced the largest deposit runoff on a seasonally adjusted basis since last August, largely because of lower time deposits. Most banks had responded to the changes in Regulation Q by raising their rates, with varying degrees of enthusiasm.

Developments such as those he had reviewed for the Sixth District, which seemed to match those taking place elsewhere, suggested to Mr. Kimbrel that changed expectations had been an important influence in recent rate changes. Therefore, he believed that a too rapid increase in monetary aggregates should be avoided even though a slight move toward greater ease might be appropriate. Accordingly, if he had a choice he would favor alternative A for the directive.

Mr. Bopp said that he, too, welcomed Chairman Burns into the Federal Reserve System. He must also bid him farewell; unfortunately, the Chairman's first meeting with this Committee was his (Mr. Bopp's) last. Veterans here would agree--or at least he hoped they would agree--that he had usually exhibited at least one virtue: brevity. He had never, however, failed to say anything that he thought might influence the result of the current--or any future--meeting.

As all of the Committee members were acutely aware, Mr. Bopp said, since September 21, 1966, the Board of Governors had been directed by law to "take action to bring about the reduction of

interest rates to the maximum extent feasible in the light of prevailing money market and general economic conditions." During the roughly three and one-half years that that directive had been in effect, selected interest rates had moved as follows:

	Yields (per cent)	
	Sept. 21, 1966	Feb. 6, 1970
20-year Government bonds	4.76 1/	6.45 2/
Aaa corporate bonds	5.49	7.97
Baa corporate bonds	6.10	8.79
Aaa municipal bonds	4.17 3/	6.28 4/
FHA mortgages	6.63 5/	8.62 6/
1-year Treasury bills	5.94	7.30
90-day Treasury bills	5.59	7.42

1/ Maturing 5/15/85
2/ Maturing 2/15/90
3/ On 9/22/66
4/ On 2/5/70
5/ For the month of Sept. 1966 (Avg. of daily figures)
6/ For the month of Dec. 1969 (Avg. of daily figures)

As he looked at those results, Mr. Bopp continued, he was reminded of a story that Bob Roosa once told him. It concerned a General Order that Omar Bradley had issued to the Third Army after a briefing session early in March 1945. The order read substantially as follows: "Conduct an aggressive defense, maintaining contact with the enemy." Over the first 48 hours that that General Order was in effect, the Third Army advanced 48 miles. Quite a defense! About as great, Mr. Bopp would say, as that maximum reduction that had been achieved in interest rates since September 1966.

One of the many conclusions Mr. Bopp had drawn from those experiences was that it was far more important to have the

Committee's Manager and Special Manager comprehend what the Committee was really trying to achieve than it was to give them precise and detailed directions that precluded any judgment on their part. At a lower level of authority he personally had suffered through the specific directives of the pegs and of bills only. Hold the Managers accountable? Of course! But let the Committee recognize also that, as the Canadian Commission on Banking and Finance had pointed out, a central bank had to have a dual orientation: toward policy and toward markets. And let it also be recognized that if the members of the Open Market Committee--Governors and Presidents alike--were really doing their jobs they would concentrate on policy and on seeing to it that the Committee had Managers and was developing future Managers who would loyally execute its policies in the market. Let the Committee not pretend to have--or be embarrassed to admit that it did not have--market sophistication. His own view was that the Committee's Managers had done a better job in executing its directives than the members had done in giving them directives.

Mr. Bopp believed that the System should allocate significant resources to developing knowledge and comprehension of the linkages among financial and real economic variables. As of today, however, its ignorance of the connections was colossal. So far this year, for example, the money suppy had grown, the bank credit proxy had declined, and money market conditions had been about unchanged--except, of course, for the effects of speeches, especially by the Secretary of the Treasury. Incidentally, how should the timing,

content, and effects of such a talk be programmed? Until the Committee received convincing answers to such questions, he would hesitate just a little bit to follow recommendations as to policy that might be provided by a computer.

Turning to policy for the next four weeks, Mr. Bopp said inflationary psychology remained strong. He would continue the present stance of policy as reflected in alternative A, with greater weight to money supply. He was, however, speaking early in the go-around this time; and he was open to conviction that another course was more appropriate. Alternative B was not greatly different, in his view.

Mr. Hickman said the people at the Cleveland Reserve Bank also welcomed Chairman Burns and wished him well.

Mr. Hickman then reported that the Fourth District Business Economists Round Table had met at the Cleveland Bank on January 30, and the 40 economists who attended had given their forecasts of GNP, prices, and industrial production. The general contour of the group's median forecast of GNP was essentially the same as that presented by the Board's staff today. For the record, the median forecast of the business economists was for a gain in real output in 1970 of less than 1 per cent, with a rise in current dollar output of just under 5-1/2 per cent. The business economists expected that inflation would remain a severe problem in 1970, although some progressive improvement was thought likely before year end. The Administration's latest economic forecast for 1970 was somewhat more optimistic than that of the

Cleveland group, although the pattern of change within the year was essentially the same--that is, no real growth in the first half and modest recovery in the second half.

Business activity continued to slide, Mr. Hickman remarked, and corrective action was needed to prevent the situation from deteriorating further in the months ahead. The new Federal Budget, which appeared to be mildly stimulative, would provide some cushion to economic activity. It had been evident for several months that a modest first step in the monetary sector was needed to set the stage for resumption of real economic growth. On the other hand, the pitfall of excessive monetary stimulation should be avoided, since such a stop-go policy would intensify the problems of inflation. For that reason, he would strongly recommend that the Committee continue the policy adopted at its last meeting of encouraging "modest growth in money and bank credit."

However, Mr. Hickman said, he had to add that the January results and the projections for February hardly seemed to meet the Committee's wishes; the net results were more nearly like what one might have expected under the last meeting's directive alternative A, calling for no change. The bank credit proxy adjusted for nondeposit sources of funds had declined at an annual rate of 3.1 per cent in January because of large run-offs in time deposits, and an even more alarming decline in the adjusted credit proxy was projected for February. He believed the Committee should induce a decline in the structure of short-term interest

rates to whatever level might be required to permit banks to obtain funds to pave the way for modest growth in aggregate credit. He favored alternative B of the staff's draft directives today, and would instruct the Manager to provide for growth in bank reserves sufficient to nudge the three-month Treasury bill rate towards the 7 per cent level, or below.

Mr. Sherrill noted that at its last meeting the Committee had adopted a directive calling for modest growth in the aggregates, under a strategy that involved aggressive use of the proviso clause and secondary emphasis on money market conditions. The results were somewhat better than he had expected, although bank credit had declined.

Mr. Sherrill said he thought the staff's presentation today had been excellent. He agreed with the general policy course they had suggested--namely, to begin the long, slow process of unwinding the System's heavy monetary restraint. In his judgment the point of inflection had been passed in the struggle against inflation. However, attitudes were still a problem, and it was important that the System avoid rekindling inflationary expectations.

Mr. Sherrill noted that the ranges of money market conditions specified in the blue book for alternatives A and B overlapped in most cases. He thought conditions at the midpoints of those combined ranges probably would work out to be the best for the coming period. He would not want to shift all the way to the alternative B targets because growth in the money supply in the first quarter

at a 4 to 5 per cent rate--as projected under that alternative--was likely to be viewed by the market as reflecting a major change in policy. Such a conclusion, in turn, might result in so large a decline in the bill rate that there would be substantial reintermediation and much more growth in bank credit than the staff had suggested. He favored alternative A for the directive, but if the aggregates appeared weak he would want the Manager to make aggressive use of the proviso clause and seek net borrowed reserves and Federal funds rates at the lower ends of the blue book ranges.

Mr. Brimmer said he was in sympathy with much of what had already been said by the voting members of the Committee. He thought the staff's presentation today had helped put the issues in perspective, and in general he agreed with the staff's conclusions. However, he felt that alternative A was preferable to alternative B for the directive on grounds of timing--grounds that he considered critical. As Mr. Hayes had suggested, the Committee had been trying for some time to achieve the current slowing of the economy and it should not reverse its course too soon. He also hoped the Committee would not lose sight of the highly unfavorable outlook for the balance of payments and would give the payments balance somewhat greater than customary weight in formulating policy over the near term.

Mr. Brimmer observed that he appreciated the Desk's problems in interpreting a directive such as the one the Committee had issued in January. He had found helpful the Manager's statement

as to how he would propose to interpret the two alternatives before the Committee today, and he hoped that the Manager would make similar presentations at future meetings.

Mr. Brimmer noted that there had been quite a bit of emphasis in the discussion today on the importance of permitting banks to regain competitiveness in issuing CD's. Early last summer he had looked into the experience of banks in 1966 and 1968 when they had reacquired the ability to compete for funds through CD sales. He would submit a table showing the findings[1/] for inclusion in the record, and would simply note that in both periods banks had been quick to recover their earlier CD losses. In view of the risk that banks would once more move rapidly to a position in which they could substantially expand their lending and investing activity, he thought the Committee should be extremely cautious in its actions at this juncture.

Mr. Maisel remarked that it seemed clear from the staff projections--which he viewed not as pessimistic but rather as realistic--that monetary policy should insure a moderate rate of growth in money and bank credit. He would define "moderate growth" at this time as an annual rate of 4 to 5 per cent in M_1 and a similar rate in bank credit. The problem, as he saw it, was how to achieve those growth rates in the aggregates while at the same time not giving the impression that the System was once more "swinging wildly from an extreme of restraint to an extreme of

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1/ Appended to this memorandum as Attachment C.

ease," and not fomenting a speculative surge on the parts of banks and dealers that would cause too rapid an expansion in the aggregates.

Mr. Maisel noted that there had been a decided easing of credit conditions as a result of speculative shifts in the markets. The problem was how to avoid adding fuel to those speculative fires in the short-term money markets, while moving onto the path the Committee thought was viable for the intermediate future. To achieve the desired growth in the monetary aggregates, he would instruct the Manager to use them as a target. He would accept as a starting point for the Manager's operations somewhat easier money market conditions, but with a proviso that the Manager should pull back if his operations seemed to be encouraging too sharp a fall in the Treasury bill rate and, therefore, too large a potential growth in the aggregates.

If the Committee favored alternative A for the second paragraph of the directive, Mr. Maisel continued, he would want to amend the opening language to read: "...while taking account of...the Committee's desire to see a moderate growth in money and bank credit...." He had already proposed a definition of "moderate" growth. He would define "firm money market conditions" as a Federal funds rate between 8 and 8-1/2 per cent and net borrowed reserves of around $700 million. As he had noted on earlier occasions, however, the question of whether the directive used the term "firm," or "ease," was unimportant to him. The money market conditions he had specified had been covered by both terms. He

would, therefore, accept either alternative A with his suggested amendment or alternative B. However, he would add the condition--not in the written directive--that the Manager should not press for the market conditions he had described if the three-month Treasury bill rate was below 7-1/4 per cent during the next two weeks or below 7.10 per cent for the remainder of the coming policy period.

In concluding, Mr. Maisel said he believed such a directive would enable the Committee to speed up the necessary creation of reserves and credit without creating an overwhelming speculative splurge that would be most difficult to contain. He would also note that the staff projections showed almost all the expected growth in the money supply as occurring within the next ten days. That meant that the Manager would know almost at once how much change he should make in order to achieve the Committee's objectives.

Mr. Daane said he thought that in its presentation this morning the staff had exceeded its usual high standard of excellence. As to policy, in line with Mr. Bopp's remarks today he felt that the question of the System's general posture was more important at this juncture than that of the precise targets to be set for open market operations. For example, even if he were to place greater weight on the money supply than he in fact did, he would not expect major differences in consequences if the first-quarter growth rate was 4 to 5 per cent, as projected under alternative B, rather than 3 to 4 per cent, as projected under A.

The significant question, Mr. Daane continued, was whether the System was to demonstrate flexibility in its stance at this time. To use one of former Chairman Martin's favorite expressions, "Steel that bends is stronger than iron that breaks." If the System remained adamantly opposed to any relaxation of its restrictive policy stance it would run the risk of losing its potential for flexibility. The Manager had noted that, to an extent at least, the market had already discounted some move on the Committee's part. As a consequence, if the System failed to give any indication of easing, interest rates were likely to reverse their recent declines and perhaps even to move above their earlier peaks. At the same time, it was necessary to avoid unduly encouraging market expectations of easing.

On balance, Mr. Daane said, he thought that the Committee should move cautiously and gradually, and only far enough initially to validate the changes that had already occurred. In effect, he favored reducing slightly the current heavy pressures on bank liquidity. That probably could be accomplished under either of the alternative directives put forward by the staff. However, his own preference would be for a second paragraph reading about as follows:

> "To implement this policy, while taking account of the current 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 probing cautiously toward somewhat less restraint and the appropriately related conditions in the money market;..."

Mr. Daane added that he held no brief for that precise language. He considered it important, however, to convey the sense that the System was not standing pat, but rather that it had undertaken a gentle and--to use an adjective Mr. Robertson had employed at the January meeting--gingerly movement toward less restraint.

Mr. Mitchell said he agreed in general with Mr. Daane's remarks. In his opinion the problem of deciding on wording for the directive today was not so much a matter of the instructions to be given to the Manager; the differences among members on that score did not seem very great. Rather, it was a matter of finding language that would make clear, when the directive was published in 90 days, the kind of decision he thought the Committee would reach at this meeting--namely, to acknowledge the lags in the effects of monetary policy and to change course at this point. He thought such a decision would be best communicated by a modified version of alternative B which called for operations "with a view to moving gradually toward somewhat less taut conditions in the money market." Such language would avoid the problems associated with the word "easier" and would indicate that the intention was to move gradually. He agreed that the move should be cautious and slow, but he also believed it should be persistent.

On the question of aggregates, Mr. Mitchell agreed that market interest rates might fall enough to permit banks to engage in some reintermediation. Nevertheless, he thought it would be a mistake to use bank credit as a guide to operations at this juncture;

as he had indicated earlier, he favored focusing on demand deposits or M_1. He also agreed that there would be no great significance to the difference between 3 to 4 and 4 to 5 per cent rates of growth in M_1 over the first quarter. But in seeking such moderate growth rates, the Manager should bear in mind that in the latest statement week M_1 had fallen below its average December level.

As to targets for money market conditions, Mr. Mitchell said he would favor a constellation including a Federal funds rate centering on 8-1/2 per cent, net borrowed reserves around $750 million, and member bank borrowing about $900 million. The Manager probably could accommodate such conditions under any of the alternative directives under consideration. Thus, while he had suggested a modified alternative B, he would not necessarily reject alternative A if the money market conditions sought were in the lower part of the blue book ranges.

Mr. Black said that in view of the lateness of the hour he would simply note that he agreed in general with the views expressed by Mr. Mitchell and would submit the statement he had prepared for inclusion in the record. That statement read as follows:

> The latest survey of Fifth District bankers and businessmen, which covers a more recent period than our national data, is the most pessimistic we've seen in several years. Respondents in all parts of the District report reduced levels of retail sales and further cutbacks in all basic construction categories. The textile industry continues in the doldrums, while manufacturers in other lines indicate reductions in new orders, backlogs, shipments, hours worked, and employment. A sizable majority of

businessmen in our survey expect a decline in activity in the months ahead.

At the national level, I think we now have enough data to indicate clearly that we are in a period of softening economic activity. The important question, of course, is how much of a downturn, if any, we shall have. I doubt that we shall have much in view of the good support, both actual and potential, in many important sectors. Business capital plans are still robust, and while these will no doubt be subject to dramatic cutbacks if expectations go sour, much of the planning in this area goes beyond short-run business prospects. Inventories do not appear to be very excessive, so I doubt that inventory liquidation will be a serious problem. Potential demand in housing is enormous, and State and local government spending remains strong. Moreover, it is reasonably clear that we are in for some fiscal stimulus in the months ahead despite the Administration's determination to keep a tight rein on the budget.

We have long realized that the economy could not stand for any substantial period of time the severe pressure to which we have been subjecting it. Despite our recent moves, I feel that policy remains excessively restrictive and I believe the time has now come for more positive relaxation. Admittedly, we still have serious inflationary problems, and I think we must be careful to avoid arousing suspicions that we are over-reacting to recession fears. I believe, however, that we have made some inroads into inflationary expectations, and I think we shall soon see some abatement of price pressures in the face of slowing demand. Accordingly, I believe we should attempt to establish a rate of expansion in the aggregates that is more in line with sustainable economic growth over the long run. It is difficult, of course, to pinpoint the best rate, or even to choose the best aggregate, but my preference would be to aim over the next several months for an increase in bank reserves at about a 4 per cent annual rate. Such a rate might occasion a larger drop in short-term interest rates than we would like, but I believe we should accept this if necessary to bring about a suitable rate of growth in the aggregates. Alternative B of the directive drafts expresses my preferences better than does alternative A, but I would prefer a directive somewhere in between.

Mr. Clay said he thought monetary policy was at a crucial point in the battle against price inflation. Price inflation itself had not been corrected or even slowed down, and price inflationary expectations remained very strong. Yet real economic activity had shown substantial response to public economic policy restraint. The response had been uneven, ranging from residential construction that was understandably too weak to business capital outlays that continued impressively strong. Manpower and other resource utilization had slackened, with unemployment and unused industrial capacity showing some increase. Consumer spending had weakened, and business profits had fallen.

In most respects, Mr. Clay continued, the results of economic policy, while slow in coming, had been those which constituted the essential forerunner to correction of the price inflation problem. The price inflation impact would be expected to lag, but the price problem had proven to be particularly stubborn. The severity of the price inflation problem was related to the momentum that had been built into the economy in the years of accelerating inflationary developments, and the inflationary expectations that had come to be established. It also was related to the institutional arrangements whereby wage patterns and the prices that flowed from them became established in negotiations between powerful labor unions and large business corporations and

were then transmitted throughout the economy. Presumably the fuller impact of the policy actions that had been taken would bring increasing restraint on price inflation over time, but the process probably would be slow. Much would depend upon the contribution that was made by fiscal policy.

Mr. Clay commented that monetary policy had been very tight for a long time. So far as he could foresee, it would need to be a restrictive force for a considerable period ahead. In view of the current and projected slowdown in real economic growth but still reflecting concern over the price inflation outlook, it would seem appropriate to permit modest growth in the financial aggregates, as decided at the last Committee meeting and as contemplated by alternative draft policy directive A for the period ahead. That would include the slightly easier money market conditions that had evolved recently and it would not preclude further easing, should market conditions so develop. On the other hand, a more substantial shift in the growth rate of financial aggregates and a considerable easing in monetary conditions, such as contemplated by alternative B, would seem to him to be premature. He did not, however, find himself in a position in which he could not support a directive somewhere between alternatives A and B.

Mr. Scanlon submitted for the record the following statement on conditions in the Seventh District:

The pressure of demand on resources in the Seventh District has eased somewhat further, but there is no evidence yet of any easing of upward pressure on prices or of any expectations that the price rise will be slowed any time soon. Manufacturing activity in the District declined further in January, and it is believed that the downtrend is continuing in February. Demand for some producer goods, notably trucks, appears now to have weakened, and demand for consumer durables continues at a reduced level. Unemployment increased appreciably in the District in December and January, labor supply has improved somewhat in most areas but is still generally tight, and increases in worker compensation have accelerated.

New claims for unemployment compensation were about a third larger in January than a year earlier in Seventh District States and about the same relative to covered employment as in the nation as a whole. The proportion of covered workers receiving unemployment compensation in late January was the largest for any January since 1965--although still well below the proportions of earlier years. In January the volume of help-wanted advertising in Chicago newspapers was down 13 per cent from a year earlier, but still large.

Auto sales declined further in January and at 21,000 were at the lowest daily rate since January 1962. Production schedules for the first quarter have been cut back to 1.8 million, also the smallest for any first quarter since 1962. The inventory of new autos has been brought below the year-ago level but on a days-sales basis is still higher than a year ago because of the decline in sales.

Steel production in recent weeks has been somewhat higher than a year ago, although well below record levels. Recently, steel orders have picked up, but order books are not as "firm" as through most of last year. The strength continued to be attributed in part to export demand.

Most capital goods producers in the District are operating at high levels, and order backlogs for some are at record levels. But there is increasing skepticism that these conditions will hold in the next several months.

Construction contracts in the District show changes similar to those for the nation, with strength in the commercial, utility, and public works sectors.

Farm real estate prices have leveled off, and some areas in the District, especially cash grain areas, report sizable declines. The current high interest rates and reduced availability of mortgage credit are important factors in this development, along with current and prospective developments in farm income. Farmers' purchases of machinery continue relatively weak and the demand for farm loans is moderate except in cattle-feeding areas where the demand is strong.

The change in total bank loans in January, after allowance for the year-end bulge and the shift of assets to holding companies, probably was not much different from other recent years.

Loans to business customers show no clear-cut trend. Consumer loans, however, appear to have weakened significantly. This undoubtedly is associated with the reduced level of auto sales, but may also reflect the shift, reported by a number of banks in last fall's survey, toward more restrictive loan policies.

So far there is little evidence that the adjustment of Regulation Q ceilings has permitted banks to recoup earlier deposit outflows, although Chicago banks did report some increase last week in negotiable CD's. CD's issued to foreign official accounts have increased in importance as a source of funds to Chicago banks in recent weeks. On the whole, large banks in the District appear to be under continued reserve pressure. Borrowing at the window has increased again, both in dollar volume and number of banks, especially among the larger banks in reserve cities. Despite accelerated sales of commercial paper by holding company affiliates, there has been a net decline in nondeposit funds of the major money market banks.

Mr. Scanlon then said he thought the object of policy now should be to return to a path of slow monetary growth. Under current circumstances, he thought money supply should be maintained in a slow rise. He did not consider it critical for the economy that bank credit show immediate expansion, since it was clear that funds were moving via other channels.

In order to achieve that posture, Mr. Scanlon would prefer that the Committee use the money supply as the primary target of

operations rather than some set of money market conditions. As the Manager had pointed out, the use of more than one aggregate for target purposes ran the risk that they might diverge, even over a fairly lengthy period. If two or more aggregates were to be used, a priority should be indicated, with ranges established for each. While he was not prepared to stay with a money supply target indefinitely, such a target appeared least likely to lead the Committee far astray at this time in view of the fact that bank credit and the reserve base were still badly distorted by Regulation Q and by the banks' resort to nondeposit sources of funds. The time horizon probably should be such as to be reflected in a three-month moving average. That should be helpful in accommodating situations where a too-abrupt change in interest rates or a problem of Treasury financing might arise if the Committee undertook to adhere closely to a specific short-run growth rate for an aggregate.

The bulge in money supply indicated for January had been far greater than expected, Mr. Scanlon noted. While he would not like to see it repeated, he would not be inclined to give that bulge much weight in deciding what should be done now.

If easier money market conditions were required to maintain some growth of money stock, Mr. Scanlon would accept them. However, he would favor qualifying the directive with a proviso in terms of some range of money market conditions.

That would provide some cushioning in the event a strong change in expectations or in credit demand were to result in an abrupt change in interest rates.

In Mr. Scanlon's opinion the staff's economic projections represented an appropriate set of conditions under which the Committee might hope gradually to moderate inflation. While he had some reservations at this time about the desirability of a money supply growth rate as large as 4 per cent in the second half of 1970, that bridge need not be crossed today.

In concluding, Mr. Scanlon expressed the view that the important thing at this time was to get some modest growth in the money supply. As he read the numbers in the blue book, alternative A of the directive drafts would do that. He would favor that alternative for the directive. However, Mr. Mitchell's modified version of alternative B would be acceptable to him, particularly if the Manager felt such an instruction was necessary to achieve modest growth in money.

Mr. Galusha said he would submit the statement he had prepared for inclusion in the record, and would note only that he had found the observations by Messrs. Bopp, Mitchell, and Daane today to be quite persuasive. His statement read as follows:

> With what the Board staff has assumed about Committee policy, its projections of GNP and other economic magnitudes seem quite reasonable. I am a little doubtful about their dollar totals for business fixed investment in the second half of the year. My judgment--based, I must admit, on

an appraisal of the prevailing mood--is that businessmen will not spend quite that much. Of course, it is always possible that the Federal Government will end up spending more than it has said it would. But that the actual second-half increase in real GNP will be smaller than the projected increase seems more likely than that it will be larger. And, as we need constantly to remind ourselves, the Board staff is even now projecting an average unemployment rate of over 5 per cent for the fourth quarter of the year.

It is discouraging that, by the Board staff's projections, we will make only modest progress through 1970 in slowing the rate of inflation. I would worry, though, about forcing a larger-than-projected increase in unemployment. The projected increase strikes me as quite large enough. So I would hope that actual Committee policy will be about what the Board staff assumed it to be--or perhaps even a shade less restrictive.

At the last meeting of the Committee it was agreed that a 2 per cent annual rate was a reasonable target for growth of the money stock. I would be inclined toward a slightly higher rate, but what is most important, it seems to me, is that we not try to compensate, or at least not fully, in February and March for the January increase.

As those who emphasize the money stock would agree, what matters is how the growth of the money stock compares with the growth of the demand for money. But the demand for money averaged sharply higher in January than in December, so it would be appropriate for the Committee to adopt a target rate of increase in the money stock of something like 2 per cent--or possibly a shade less than 2 per cent--for this month and the next.

Being inclined to discount somewhat, if not totally, the sharp January increase in the money stock, I have to be for a directive about half way between the two alternatives prepared by the staff. As I figure it, staying with the 2 per cent annual rate target implies about a 4 to 5 per cent annual rate of increase from December to March.

Mr. Swan commented that conditions in the Twelfth District were not significantly different from those in the nation as a whole. Accordingly, he would note only that data for the very small sample of West Coast savings and loan associations reporting

to his Bank suggested that the outflows from such associations, that had begun after the year-end interest crediting period and continued through January, were extending into early February.

Turning to policy, Mr. Swan said he did not believe the time had arrived for a substantial easing. He had welcomed the call for modest growth in the aggregates contained in the last directive and felt that that course should be pursued. In that regard he found the blue book projection under alternative A of a 3 to 4 per cent rate of growth in the money supply over the first quarter--that is, in terms of the level in March relative to December--to be quite satisfactory. As the blue book indicated, however, to achieve that growth rate it might be necessary for money market conditions to be moved toward the lower end of the ranges specified for alternative A.

Mr. Swan added that he would not object to a version of alternative B along the lines suggested by Mr. Mitchell.

Mr. Coldwell submitted for the record the following statement concerning economic conditions in the Eleventh District:

> There is nothing of substance to report on economic activity in the Eleventh Federal Reserve District, since we still appear to be riding a crest, supported by vigorous oil activity which offsets the weakening tendencies in durable goods production and the declines in housing. There is an undertone of weakness in retail sales, though presently available data do not reflect it. This undertone is manifested in the rash of special sales efforts, particularly at automobile, appliance, and furniture stores.

The financial community in the District is both confused and perplexed as disintermediation has accelerated and liquidity has narrowed further. More banks are seeking off-balance-sheet financing and the District banks' net purchases of Federal funds have grown to a daily $700 million. Pressures continue to concentrate on the large banks, although a few suburban and especially aggressive banks are feeling some strain. Most banks in the agricultural areas are generally easy because of the present seasonal lull in agricultural loan demand but many report considerable concern over the seasonal needs coming in the next 90 days unless conditions change sharply.

Thirteen large savings and loan associations reported a net outflow of $19 million from a total savings base of $1,609 million during January, but they also reported a number of new small accounts moderating the outflow. Mortgage commitments are down sharply but those being made are at 9 per cent plus one point, or very close to the Texas usury ceiling of 10 per cent.

With regard to national economic conditions, Mr. Coldwell said that he viewed the coming three-month period as the primary testing ground for economic stabilization policy. If a further orderly decline in real output could be achieved, along with some additional impact on business profits, inventory, and capital spending, then he believed there might develop a moderation of credit demands and a true, rather than expectational, decline in interest rates. With that should come a lessening of inflationary pressures.

Thus far, Mr. Coldwell continued, most of the retrenchment in activity appeared to have been in the durable goods industries. He thought, however, that to make a true correction it would be necessary to spread the impact of restraint to all segments of the economy. Otherwise there was risk of a resurgence as personal

income and purchasing power expanded with the tax cuts and with stimulative Social Security and wage increases. To reach the other segments would require a continued policy of monetary restraint--one which did not permit further ease and did not support market expectations of ease. The Committee was, in his opinion, at a crucial testing point; if it backed away, all its efforts and the costs already paid could prove to have been in vain.

Mr. Coldwell said he had watched with great interest the results under the modified form of directive adopted at the last meeting. As the members would recall, at that meeting the monetary aggregates had been expected to show a varied pattern, roughly as follows: for the money supply, little change in January, a strong increase in February, and a decline in March; and for the bank credit proxy, moderate declines in January and February with some increase in March, but a net decline for the quarter as a whole. As the period since January 15 progressed, however, the money supply projection for January had proved wide of the mark; money supply increased in that month at an annual rate of 9 per cent, while the credit proxy had declined at a 3 per cent rate. At the same time, Federal funds rates had been in a 9 to 9-1/4 per cent range on most days, while net borrowed reserves had averaged about $900 million.

Mr. Coldwell noted that the Desk's operations early in the period following the last meeting were at least influenced by

the projection for no change in the money supply in January. But then the money supply was found to be ballooning while the credit proxy was remaining weak. A divergence between the two aggregates, the possibility of which had been discussed at the last meeting, had in fact developed. The problems created by those crosscurrents, coming in the midst of a Treasury financing, had been further compounded by public statements which had led to a shift in market expectations. As a result of that shift, Treasury bill rates had declined sharply and Government bond prices had risen.

Mr. Coldwell believed the Desk's actions had been generally appropriate, given the multitude of conflicting factors among market conditions, objectives, and Committee desires. However, he thought the Committee should carefully reconsider the directive and the response it wanted from the Desk. If monthly aggregate targets were to be followed, the accuracy of projections of those targets had to be improved. Otherwise the Desk might be injecting reserves only to find that revised estimates called for reserve absorption. Even if the Committee were to follow quarterly targets, he thought that ample room should be left for revisions and that the more conservative course should be followed. Such a course would not, as he saw it, have permitted an increase in the money supply at a 9 per cent annual rate in January. Moreover, as he viewed the possibilities over

the next two months, he was not convinced that money supply or the bank credit proxy would track the path projected in the latest blue book. He saw at least some good reasons to think that the Government deposit decline of February might boost money supply, and that a slowing or even reversal of time deposit outflows might raise the adjusted proxy.

Mr. Coldwell went on to say that he hoped he did not convey the impression that his crystal ball was far clearer than those of the Committee's projectors. His point was that projecting the monetary aggregates was very difficult and that to make policy, or even to shift policy under a proviso clause, on the basis of those estimates was a very hazardous course. Moreover, there was a real problem of the extent to which the System could influence the aggregates even if its estimates were correct. A 9 per cent rate of growth in the money supply had been permitted in January. If the estimates proved bad for February and March and the quarterly average even approached the January figure, the observers who had been critical of the Committee's early and sharp policy reversals would have a perfect case in point. And yet, to have avoided the January run-up completely would have required a massive absorption of reserves, just as avoidance of the projected shortfall would require very heavy reserve injections. Such an on-again-off-again reserve policy would, he felt certain, upset market conditions and introduce such monumental uncertainties as almost to assure a disorderly market.

Of course, Mr. Coldwell commented, to avoid that problem the Committee could accept the one-month increase and hope that subsequent months would moderate its impact. That was the course of action being considered, but if the results of February and March did not moderate the January increase then there would be a very large quarterly increase. In view of those problems and, of course, of his own biases with respect to the aggregates, he felt that he had to reserve judgment on the use of such guides to policy.

In Mr. Coldwell's judgment, the results of the past four-week period had left the System in a weaker policy stance than in December. More importantly, the market had been permitted to believe that policy was changing and that ease was just around the corner. He was concerned that a shattering of those changed expectations could lead to abrupt market moves inimical to the System's stabilization objectives. However, he was more concerned that the System stay on an even but heavily restraining course until correction was achieved.

Mr. Coldwell said he applauded the Board staff's economic review and found that he was largely in agreement with the results under their assumptions. He was very concerned, however, by the fact that their projections did not call for any marked correction of the underlying inflation. The expectation would rather seem to be for a shallow and short-lived valley, which might be followed by a resumption of strong growth and an acceleration of price

increases. The depth and breadth of the valley was of critical importance to the System's efforts to attain economic stabilization. He did not want to pay any higher price than necessary, but at the same time he did not wish to give up in the fight against inflation before a real victory had been achieved. On balance, he would prefer paying the requisite price.

Mr. Coldwell remarked that he would support a directive centering on firm money market conditions, with a longer-range objective of a small increase--at about a 2 per cent annual rate--in the monetary aggregates over the quarter. He did not believe the Committee should accept the 4 per cent growth rate now envisaged, nor did he accept a 3 to 4 per cent growth rate as consistent with the objective of "modest" growth. His concept of firm money market conditions would include a Federal funds rate averaging from 9 to 9-1/4 per cent, net borrowed reserves of $900 million to $1.1 billion, and member bank borrowings averaging $1 billion to $1.2 billion.

In sum, Mr. Coldwell would accept alternative A, with money market conditions to be maintained at the higher end of the ranges specified in the blue book.

Mr. Morris said he thought the events of the past four weeks had clearly supported the Committee's action at its last meeting in moving toward a less restrictive policy. The economy had moved into a phase of contraction, but the indicators

still suggested to him that the adjustment would be a shallow one--something like that of 1966-67. The rate of decline in the leading indicators was still rather modest in general, and the economy had been rendered less vulnerable to severe decline by the fact that there had not been, in 1968 and 1969, a major build-up in inventories. The staff projections appeared reasonable to him.

In the current economic environment, Mr. Morris remarked, a moderately expansionary policy appeared appropriate. He thought the Committee should be aiming for a 3 to 4 per cent rate of growth in both bank reserves and the money supply in the period immediately ahead.

Mr. Morris suggested that the Manager should be sensitive to the probability that, in a contracting economy, the projections of growth rates in the aggregates were likely to err on the low side. For that reason, he thought the Manager should be instructed to bias his actions toward the higher side of the projections. The bulge in the money supply and bank reserves in late December and early January had now been erased completely, and the estimates for the week ending February 4 were below the average levels for December. That suggested to him that, if bank reserves and the money supply were to grow at a 3 to 4 per cent rate during the first quarter, short-term money market rates would have to decline from their current levels.

Nevertheless, Mr. Morris continued, he thought it would be unwise to pursue an aggressive policy toward lower interest rates, as alternative B of the staff's directive drafts suggested. He would like to see primary emphasis placed on the goal of a 3 to 4 per cent growth rate for bank reserves and the money supply, while letting interest rates be established by the interaction of that policy, the demand for money and credit, and the state of expectations. He thought the product of that interaction would be a trend toward lower rates, but he would not want such a trend to be forced by the Manager.

Mr. Morris said he would support alternative B amended in the manner proposed by either Mr. Daane or Mr. Mitchell. As he understood it, both of those proposed directives would require the Manager to move cautiously on interest rates unless more severe moves were required to reach the aggregative target.

Mr. Robertson made the following statement:

> The presentations and the comments at this meeting clearly describe an economy in process of cooling. But this is a process that is not yet completed. Prices and wages are still rising sharply, and inflationary expectations have by no means disappeared. What is more important, we cannot yet be confident that they will disappear. We know that the lagged effects of our restraint policies will be bearing down hard in the months ahead, but we cannot be sure whether they will suffice. The current inflationary virus has already proven unusually resistant to treatment, and it is much too early to pronounce the patient cured.
>
> Some risks are associated with every policy alternative open to us today, but I think the biggest risks attach to a decision to ease up too soon. It took a great deal of effort to achieve the current degree of

fiscal and monetary restraint. If we let go now, and then find ourselves facing a repetition of the 1968 resurgence, I think general stabilization tools will have been discredited and the country could be drawn to a whole new set of harsh and arbitrary controls. That eventuality I regard as so damaging to our long-run national interest that we must be very careful not to trigger it.

On the other side, of course, holding on to general restraint too long runs the risk of courting a significant recession. But I, for one, am not afraid of the spectre of recession. A flattening or fractional decline in real growth for two quarters will, in my judgment, help and not hinder our long-run economic performance, even if some statisticians insist on labeling such an interval a recession. And a really sizable recession--one with big drops in real output and employment--I believe can and will be forestalled by the combination of timely policy changes and big backlogs of deferred demands. From all I see and hear, I think the private spending backlogs built up over this relatively long period of tight money are unusually strong, and I believe that enough of them will become active in the event of a relaxation of pressures on money and resources so as to avoid a major economic slide.

That being so, I am ready to hold at least a little longer to our present posture of monetary restraint. To be more specific, I would like to see money and bank credit growth of no more than modest dimensions, and if such growth rates can eventuate with no easing of money market conditions, I am prepared to see the Manager continue to maintain money market pressures about as they are. On the other hand, I would not object to some decline in interest rates, should that develop either because of changing market attitudes or because of some short-fall in aggregate credit demands.

I think the kind of directive the Committee adopted last time is well suited to my general views. Accordingly, I would be willing to vote for directive draft alternative A, as distributed by the staff. The specifications in the blue book associated with that directive language are acceptable to me.

Chairman Burns said he thought the members were not very far apart in their views on policy today. From the discussion it appeared to him that there was a certain consensus to the

effect that some movement away from the prevailing degree of restraint would be salutary at this time. He shared that view, and regretted that time was not available today for him to explain his reasoning in full.

Turning to the second paragraph of the directive, the Chairman remarked that he found neither of the two alternatives proposed by the staff to be satisfactory. He did not favor A because, as he interpreted it, it called for a "wait-and-see" approach with no easing in money market conditions unless and until it became clear that the aggregates were not showing enough growth. Alternative B seemed to go too far in the other direction; it called for more easing at the outset than he would consider desirable, and it did not include a sufficiently clear-cut instruction to the Manager to react promptly if the aggregates were growing too rapidly. His preference was for language intermediate to A and B--which for convenience might be called "alternative C"--reading as follows:

> To implement this policy, while taking account of the current Treasury refunding, possible bank regulatory changes and the Committee's desire to see moderate growth in money and bank credit, System open market operations until the next meeting of the Committee shall be conducted with a view to moving gradually toward somewhat less firm conditions in the money market; provided, however, that operations shall be modified promptly to resist any tendency for money and bank credit to deviate significantly from a moderate growth pattern.

The Chairman added that he saw a number of virtues in that language. It made clear that the easing of money market

conditions was intended to be gradual, and that the purpose was to encourage growth in bank credit and the money supply at a moderate rate. Moreover, it provided specifically for a prompt modification of operations if the aggregates were growing more than moderately--an instruction which he considered highly important.

Mr. Hayes observed that he had real reservations about the Chairman's proposal, because it called for an overt--even though gradual--move toward less firm money market conditions. It had seemed to him clear from the discussion today that a majority of the voting members were inclined to the policy course indicated by alternative A. He had also been impressed by the number of comments to the effect that the money supply was a more significant aggregate at this juncture than bank credit. In that connection, he noted that--while projections admittedly were subject to wide margins of error--the Board's staff had projected a first-quarter growth rate in the money supply of 3 to 4 per cent under alternative A. He was not convinced that an overt move toward less firm conditions was needed to achieve moderate growth in the aggregates and he would be reluctant to see the Committee call for such a move at this time.

Chairman Burns remarked that the question of whether a majority favored some move toward less firm money market conditions could, of course, be readily resolved by a vote. He personally had arrived at that position partly on the basis of an independent

study he had made of the current state of the economy. As he assessed the evidence, it was consistent with the hypothesis that the economy was now entering a recession, although it did not prove that to be the case. He thought the Committee could not afford to ignore that possibility, nor could it ignore the evidence assembled by its own staff. If the Committee held to its present policy course too long and failed to agree now on a gentle, gradual move toward less firm conditions, it might well be forced by developments to make a drastic shift in policy in only a few months.

Mr. Mitchell said he considered the general thrust of alternative C to be quite close to that of the language he had proposed earlier, and he had no objection to it. There might, however, be a problem with the specific wording, if it implied that the Committee was seeking some positive growth in bank credit in the period between now and the next meeting. He doubted that it would be possible to achieve such growth with the kind of change in money market conditions envisaged.

In reply to the Chairman's request for comment, Mr. Partee indicated that if the money market conditions associated with alternative C were intermediate to those given in the blue book for alternatives A and B, they could be consistent with some expansion in bank credit in March, since the three-month bill rate

would have to fall only another 10 or 15 basis points to make it possible for banks to increase somewhat their sales of large-denomination CD's. It was not likely, however, that the expansion in March would be great enough to produce positive growth in February and March together.

Mr. Partee added that the staff anticipated some growth in bank credit in the second quarter even if the Committee today adopted alternative A, and more growth if it adopted B. Accordingly, it would expect growth under alternative C.

In the discussion that followed, several possible means of coping with the problem Mr. Mitchell had noted were considered. A number of members concurred in a staff suggestion that the words "over the months ahead" be inserted after the reference to "the Committee's desire to see moderate growth in money and bank credit."

Mr. Hayes noted the large errors to which the projections of the money supply and bank credit were subject, and said he would like to underline the difficulties that would be posed for the Manager if the Committee formulated its policy in terms of such projections. Moreover, considering the wide swings from month to month in the rates of change of the aggregates, he doubted that it was wise to place much stress on the growth rates in a particular month.

Chairman Burns expressed the view that the Committee's main emphasis should be placed on the objectives it sought. Technical considerations might result in misses from target, but that fact alone did not justify avoiding certain types of targets that the Committee thought were proper on other grounds.

Mr. Brimmer commented that he could not support alternative C for the directive; he favored alternative A, in the form submitted by the staff. He noted that alternative A called for continuing the course adopted at the January meeting, when the Committee had agreed to move slightly away from its previous posture of extreme restraint. The decision at that meeting had been a compromise between "no change" and "easing" alternatives before the Committee then. In his judgment the policy stance adopted then was still appropriate, in light of the persistence of inflationary pressures and the state of market expectations. The necessity for adopting alternative C at this particular juncture was not clear to him, especially in view of the blue book projection of first-quarter money supply growth at a 3 to 4 per cent annual rate under alternative A.

Mr. Brimmer added that he agreed with the Chairman that technical considerations of the sort Mr. Hayes had mentioned should not be permitted to override other considerations in the Committee's choice of policy targets.

Mr. Daane concurred in Mr. Brimmer's concluding observation. He then noted that he could accept alternative C, which seemed quite close in spirit to the directive language he had proposed earlier. However, he still thought his own proposal was preferable. For one thing, the instruction in alternative C to move "gradually" toward less firm conditions could be read to imply a longer time horizon for that move than he thought the Committee would necessarily intend. For another, it was quite possible that the objective of moderate growth in the aggregates could be achieved without a change in prevailing money market conditions. The language he had suggested would seem to give the Manager a desirable degree of flexibility in achieving the Committee's objective with respect to the aggregates.

Mr. Galusha observed that, as his prepared statement indicated, he also favored a directive intermediate to alternatives A and B. He was not unduly concerned about the precise wording of the directive, which would not be published for 90 days in any case. But it seemed to him that some small shift in policy--whether described as cautious, probing, gradual, or whatever--was needed now in light of the economic situation as portrayed in today's chart show.

Mr. Hayes said it was not at all clear to him that a shift in policy was needed now. The Committee's greatest mistakes in the

past, he thought, had resulted from moving too soon. At the moment inflation appeared to be a greater risk than recession; from the evidence available so far, any recession was likely to be quite mild.

Mr. Maisel expressed the view that the Committee's major mistakes had not been in moving too soon but in moving too abruptly and by too much. The longer a move was postponed now, the greater the risk that it would be abrupt and too large when made. To his mind, that was a major argument in favor of adopting alternative C today.

Mr. Sherrill said he would support alternative C; he thought it expressed better than A the kind of policy course he had in mind.

Mr. Francis remarked that he also thought C was better than A--particularly if, as had been suggested, the words "over the months ahead" were added following the reference to moderate growth in the aggregates. He was somewhat surprised that an objection had been raised to C on the grounds that it called for an "overt" change since, as Mr. Galusha had noted, the directive would not be published for 90 days.

Chairman Burns observed in that connection that it was of utmost importance that the confidentiality of the proceedings at the meeting today be preserved. That was, of course, true with respect to all of the Committee's meetings; he emphasized it at this time because of the sensitive state of the financial markets.

Mr. Hayes said he agreed completely with the Chairman's comment on confidentiality. Nevertheless, he thought the chances were very small that the Committee could adopt alternative C today without having the fact of a change in policy detected by sophisticated market observers. That would exacerbate the situation already existing as a result of the widespread market expectations of an easing move.

Chairman Burns remarked that expectations no doubt could have a powerful effect on financial markets in the short run, but in the longer run market developments were determined by underlying conditions. In any case, he thought the Committee should follow the course it believed proper regardless of the risks involved in guesses on the part of market observers.

Mr. Robertson said he would be prepared to vote favorably on alternative C except for doubts about the wisdom of using bank credit as a target variable. In view of the difficulties of controlling bank credit at this juncture, he would prefer to eliminate the reference to it from the directive and to set targets in terms of bank reserves and money, or the latter alone.

Mr. Partee commented that in principle there were advantages to the use of bank reserves for target purposes. Before that would be practicable, however, some means would need to be found for dealing with certain problems arising from the large number of factors that

affected the timing and nature of movements in reserves. In that connection, he noted the staff was projecting that total member bank reserves would decline by about $600 million on average in March.

Mr. Hickman observed that the money supply also behaved erratically in the short run, in part because it was affected by fluctuations in the Treasury's balances. For that reason he thought it was better to use both bank credit and money for target purposes.

Chairman Burns remarked that in his own thinking on monetary policy he had tended to focus more on bank credit than on the money supply because the former ordinarily was subject to closer control by the System. As to the present situation, the Committee could change its directive at the next meeting if problems arose with respect to the performance of the aggregates.

Mr. Coldwell noted that a decline in the average level of the money stock currently was projected for February. He asked whether the move "toward somewhat less firm conditions" called for by alternative C was expected to be substantial enough to produce positive growth in money in February.

Chairman Burns said it was his understanding that the level of the money supply in February was already fairly well determined and would not be affected much by the policy decision today. He

was thinking in terms of money supply growth beginning in March, and continuing through the second quarter, at roughly a 4 per cent annual rate.

Mr. Axilrod added that in view of the exceptionally high level of the money supply in January, on average, it would be particularly difficult to bring about positive growth from the January average to the February average by changing money market conditions at this time. During the course of February, however, both the money supply and bank credit probably would turn up, and the projections implied that under a policy alternative about midway between A and B their average levels in March would exceed those in February by a moderate amount. Thus, the projections seemed broadly consistent with the language of the proviso clause in alternative C referring to "a moderate growth pattern" for the two aggregates.

Mr. Robertson suggested that it would be helpful if the Manager would explain how he would propose to interpret alternative C if the Committee adopted it today.

Mr. Holmes replied that he understood alternative C to call for shading money market conditions in the direction of less firmness, beginning immediately and moving cautiously and gradually. How far the shift would be carried would be determined by developments with respect to the aggregates. In that connection, he assumed that the Committee would want him to focus on current estimates and projections

for the near-term--through March--rather than on projections for two or three months ahead. It was possible that very little change in money market conditions would be needed, since present staff projections suggested that the money supply would grow at a 3-1/2 or 4-1/2 per cent annual rate in the first quarter under alternative A and he assumed that the Committee would not want to see money grow at a rate much in excess of 3-1/2 per cent. As had been indicated, it was likely to prove quite difficult to have much effect on bank credit in the short run because of the workings of the Regulation Q ceilings.

Chairman Burns remarked that it was still his opinion that the members did not differ greatly with respect to the appropriate policy course; to a large extent the differences of view related to the choice of words for expressing the policy decision. He then suggested that the Committee vote on a directive consisting of the staff's draft for the first paragraph and alternative C, amended in the manner suggested earlier, for the second paragraph.

Mr. Bopp said he planned to vote favorably on the proposed directive. However, he was not persuaded that the outcome would be very different from what might have been accomplished under alternative A, given the blue book projection that the money supply would grow in the first quarter at a 3 to 4 per cent annual rate under that alternative.

Messrs. Robertson and Scanlon concurred in Mr. Bopp's comment.

Mr. Daane said he would vote favorably, since in his view the objective of C was not appreciably different from that of the directive language he had proposed earlier.

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

The information reviewed at this meeting suggests that real economic activity, which leveled off in the fourth quarter of 1969, may be weakening further in early 1970. Prices and costs, however, are continuing to rise at a rapid pace. Long-term market interest rates recently have fluctuated under the competing influences of heavy demands for funds and shifts in investor attitudes regarding the outlook for monetary policy. Bank credit declined in January but the money supply increased substantially on average; both had risen slightly in the fourth quarter. Flows of time and savings funds at banks and nonbank thrift institutions have remained generally weak since year end, and they apparently have been affected little thus far by the recent increases in maximum rates payable for such funds. The U.S. foreign trade balance improved somewhat in December, as imports fell off. The over-all balance of payments has been in substantial deficit in recent weeks. 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 current Treasury refunding, possible bank regulatory changes and the Committee's desire to see moderate growth in money and bank credit over the months ahead, System open market operations until the next meeting of the Committee shall be conducted with a view to moving gradually toward somewhat less firm conditions in the money market; provided, however, that operations shall be modified promptly to resist any tendency for money and bank credit to deviate significantly from a moderate growth pattern.

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

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) February 9, 1970

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 10, 1970

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real economic activity, which leveled off in the fourth quarter of 1969, may be weakening further in early 1970. Prices and costs, however, are continuing to rise at a rapid pace. Long-term market interest rates recently have fluctuated under the competing influences of heavy demands for funds and shifts in investor attitudes regarding the outlook for monetary policy. Bank credit declined in January but the money supply increased substantially on average; both had risen slightly in the fourth quarter. Flows of time and savings funds at banks and nonbank thrift institutions have remained generally weak since year end, and they apparently have been affected little thus far by the recent increases in maximum rates payable for such funds. The U.S. foreign trade balance improved somewhat in December, as imports fell off. The over-all balance of payments has been in substantial deficit in recent weeks. 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.

SECOND PARAGRAPH

Alternative A

To implement this policy, while taking account of the current 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.

Alternative B

To implement this policy, while taking account of the current Treasury refunding, possible bank regulatory changes, and the Committee's desire to see moderate growth in money and bank credit,

System open market operations until the next meeting of the Committee shall be conducted with a view to moving toward somewhat easier 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.

ATTACHMENT B

Simulation of Alternative Rates of Monetary Expansion [1]

Projected Rate of Change in M [2]	Actual [3]	Projected							
	IV/1969	I/1970	II/1970	III/1970	IV/1970	I/1971	II/1971	III/1971	IV/1971
0 Per Cent									
Rate of Change in Y	4.4	4.6	3.4	2.5	2.0	1.3	1.2	1.2	1.2
Y*	-0.1	-0.4	-1.4	-2.2	-2.7	-3.1	-2.7	-2.2	-1.6
P	4.7	5.0	4.9	4.8	4.7	4.5	4.0	3.5	2.8
Unemployment Rate	3.6	4.3	4.7	5.1	5.6	6.1	6.6	7.1	7.6
3 Per Cent									
Rate of Change in Y	4.4	4.8	4.6	4.7	5.1	4.7	4.6	4.6	4.6
Y*	-0.1	-0.2	-0.3	-0.2	0.1	-0.1	0.1	0.5	0.9
P	4.7	5.0	4.9	4.9	4.9	4.8	4.5	4.1	3.7
Unemployment Rate	3.6	4.3	4.6	5.0	5.3	5.6	5.9	6.2	6.4
6 Per Cent									
Rate of Change in Y	4.4	5.0	5.6	6.9	8.1	8.1	8.0	8.0	7.9
Y*	-0.1	0.0	0.7	1.8	2.9	2.9	3.0	3.1	3.4
P	4.7	5.0	4.9	4.9	5.1	5.1	5.0	4.7	4.4
Unemployment Rate	3.6	4.3	4.6	4.9	5.0	5.1	5.2	5.3	5.3

1/ Key to Abbreviations:
Y = Nominal GNP
Y*= Real GNP
P = GNP Price Deflator
M = Money Supply

2/ Rates of change in money calculated from January 1970. Government expenditures are assumed to grow at a 6 per cent annual rate from IV/1969.

3/ All figures except the unemployment rate are preliminary.

February 9, 1970

ATTACHMENT C

CD ATTRITION AND RECOVERY BY SIZE OF BANK, 1966-69
(Amounts are in millions of dollars on CD maturity survey dates)

	Total WRBs reporting	Size of bank--total deposits ($ millions)						
		200 & under	200-500	500-1,000	1,000 and over			
					Total	Prime		Non-prime
						N.Y.	Other	
1966 period								
Outstanding CD's:								
July 27, 1966	18,272	599	1,779	2,381	13,513	6,976	4,178	2,359
Nov. 30, 1966	15,460	621	1,692	2,367	10,780	5,115	3,419	2,279
CD change--$ mil.	-2,812	+22	-87	-14	-2,733	-1,861	-759	-80
%	-15.4	3.7	-4.9	-0.6	-20.2	26.7	-18.2	-3.4
Number of months after low to recover CD losses:								
90%	2		2	1	4	8	2	2
100%	3		2	1	4	9	3	2
1968 period								
Outstanding CD's:								
Feb. 28, 1968	21,085	920	2,421	3,504	14,240	6,222	5,071	2,947
June 26, 1968	19,268	954	2,424	3,443	12,448	5,406	4,303	2,739
CD change--$ mil.	-1,817	34	3	-61	-1,792	-816	-768	-208
%	-8.6	3.7	0.1	-1.7	-12.6	-13.1	-15.1	-7.1
Number of months to recover CD losses:								
90%	1			1	1	4	2	1
100%	1			1	2	4	2	1
1969 period								
Outstanding CD's:								
Nov. 27, 1968	24,307	1,102	2,871	4,387	15,948	6,985	5,503	3,460
Apr. 30, 1969 (most recent)	17,612	1,151	2,698	3,429	10,334	3,519	4,069	2,747
Change: $ mil.	-6,695	49	-173	-958	-5,614	-3,466	-1,434	-713
%	-27.5	4.4	-6.0	-21.8	-35.2	-49.6	-26.1	-20.6
MEMO: Number of banks	265	93	85	50	37	7	12	18