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, September 9, 1969, at 9:30 a.m.

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

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

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

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

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

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

Messrs. Eisenmenger, Taylor, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Atlanta, and San Francisco, respectively
Messrs. Hocter and Monhollon, Vice Presidents of the Federal Reserve Banks of Cleveland and Richmond, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Messrs. Meek and Bowsher, Assistant Vice Presidents of the Federal Reserve Banks of New York and St. Louis, respectively

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on August 12, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on August 12, 1969, was accepted.

By unanimous vote, the action of Committee members on August 27, 1969, to increase the swap line with National Bank of Belgium to $500 million, with a conforming amendment to paragraph 2 of the authorization for System foreign currency operations, effective September 2, 1969, was ratified.[1/]

1/ Committee members had initially voted on August 15, 1969 to authorize an increase in the Belgian swap line from $300 million to $500 million, effective August 18. This increase was not executed. Subsequently, the members took the action noted above.

Mr. Coldwell noted that in his telegram to the Secretary indicating that he approved the increase in the Belgian swap line he had also expressed the opinion that the Committee was responding to successive crises by making swap line increases without careful study of the total contingent liability being created or the long-range implications of the enlargement of the swap network. He had suggested that the Committee's staff be asked to begin an intensive analysis of the swap network, including such matters as its basic purposes, uses, problems, ultimate size, maturity limits, availability with and without conditions, and its place in the spectrum of international financial aid to and from the United States and foreign nations.

Chairman Martin expressed the view that Mr. Coldwell's suggestion was a good one. He proposed that Mr. Coombs and the staff at the New York bank be asked to work with the Board's staff in making such a study. There was general agreement with the Chairman's proposal.

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 August 12 through September 3, 1969, and a supplemental report covering the period September 4 through 8, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said there had been no change recently in the Treasury's gold stock and the Stabilization Fund's holdings of gold were virtually unchanged. Fortunately, the free gold markets were still feeling a number of bearish influences. It appeared that the deficit in South Africa's balance of payments would persist for some time and that South Africa probably would have to market most of its current gold production. The Swiss banks that had been acting as agents for South Africa apparently were becoming worried about their own long positions in gold. There also were reports of Russian sales of gold in the market, but those reports had been denied by the British at the meeting in Basle this past weekend.

On the exchange markets, Mr. Coombs continued, quiet and orderly conditions had reemerged recently but the general atmosphere was still one of grave apprehension. The concern was reflected in forward rates; the discount for three-month sterling was about 9 per cent per annum and that for the Belgian franc was about 7 to 7-1/2 per cent. The forward rate for the French franc also was a bit on the weak side.

The impact on sterling of the French devaluation had been magnified by the publication of figures indicating a worsening in the British trade balance in July, Mr. Coombs said. Since the French devaluation the British had experienced a net loss of around $500 million, of which they had financed $310 million by further drawings on the Federal Reserve swap line. Their swap debt to the System was now $1,125 million, leaving $875 million still available under the line. While that might appear to be a substantial margin it was worth remembering that the British had lost approximately $700 million during each of the two recent waves of speculation on a revaluation of the mark, in November 1968 and May 1969. Since the German election scheduled for September 28 was so close, it was entirely possible that a new rush into the German mark would not be stopped by an official denial that the mark was to be revalued. All of Britain's luck was not bad, however; he gathered that they hoped to be able this week to publish new trade figures indicating that exports had risen to a record level in August. The picture would be tarnished a little if, as seemed likely, imports also rose somewhat, but on balance the announcement of such trade figures could help the British get through a difficult period.

Turning to the French franc, Mr. Coombs remarked that since devaluation the French had taken in somewhat more than $300 million, mainly as a result of a reversal of leads and lags. There was no evidence that French capital was being repatriated, and he doubted that there would be such evidence until the question of the mark parity was resolved. Also, the franc was under pressure from the Euro-dollar market at a time when the French authorities felt that they had pushed domestic credit restraint almost to the limit.

Mr. Coombs commented that there were no indications of a basic imbalance in the Belgian position; the pressures against the Belgian franc appeared to be essentially speculative. That currency was particularly vulnerable to the pull of the Euro-dollar market, and it remained exposed to talk about a possible mark revaluation. It seemed to him that the recent increase in the System's swap line with the National Bank of Belgium constituted a basic protective step which had been essential to the effort to hold the international financial situation together. In his judgment a collapse of the Belgian franc would have effects in the financial area analogous to those of the Belgian military collapse in the First and Second World Wars.

Mr. Coombs commented that the German mark had been roughly in balance in recent weeks. However, the spot rate was very close to the ceiling and at any moment there could be a renewed heavy rush into the mark. At present speculators were holding off in the expectation that the Germans would telegraph any action well in advance. Although the speculators were waiting until the "last moment," that moment could arrive at any time, particularly since the German election was only three weeks away. There was a major risk that market opinion would suddenly crystallize and lead to a repetition of the speculative burst of last May, although probably on a larger scale. In general, the next few weeks were likely to be decisive. A mark revaluation after the German election might help clear the air and be followed by a period of reasonable calm. If the mark was not revalued, it was possible that a number of European currencies would become gradually undermined and that at some point one or another would break, with others following. Such a sequence of events obviously would have serious implications for the dollar.

In the past year or so, Mr. Coombs observed, there had been a substantial increase in the volume of transactions under the System's swap network. That development reflected the fact that to all intents and purposes monetary gold stocks had become frozen; no country wanted to sell gold. In that context, the swap network was now functioning not simply as a major bulwark against speculation but more generally as the main settlements mechanism of the international financial system. It was difficult to see how the present system would have worked in the absence of the swap network. Such a view was becoming general among the European central banks. Some of the

Europeans who earlier had expressed concern about the risks of abuse of the swap facilities were now among the strongest supporters of the networth.

Mr. Coombs noted that both he and Mr. Robertson had attended the meeting in Basle over the past weekend. During the course of the meeting he had raised the question of possible postponement of the September instalment that Britain owed under the first sterling balance credit package that later became known as the "First Group Arrangement." As the members would recall, he had commented on that possibility at the previous meeting of the Committee, and had discussed it in more detail in his memorandum of August 26, 1969.[1/] A number of the Governors at the Basle meeting objected to the proposal because of concern about the risk of leaks of any such action. The risk was considered particularly serious because in a number of cases it would be necessary to consult on the matter with governments, since governmental guarantees were involved. An alternative procedure was worked out, under which the Bank for International Settlements would take over $75 million due other Europeans by issuing a special credit to the British.

1/ A copy of this memorandum entitled "Repayment Schedule: First Group Arrangement," has been placed in the Committee's files.

In effect, the credits to the British would be reshuffled with more owed to the BIS and less to European countries. In addition, the United States agreed to a postponement of the instalment due to it in September, on the understanding that when the British were in a position to pay the United States would receive a pro rata share. On the whole, he thought the arrangement was adequate.

In that connection, Mr. Coombs continued, he had suggested in his memorandum that the United States should take any repayments in the form of a reduction in Britain's drawings on the System swap line. He subsequently had shifted his view, however, and now thought it would be preferable to accept repayment in the form of equal reductions in the guaranteed sterling holdings of the System and the Treasury. In his judgment such a procedure would be cleaner and more understandable in a funding arrangement of the sort in question.

Finally, Mr. Coombs said, he might mention that at the Sunday evening dinner at Basle there had been a lively discussion of an article by Peter Jay that had recently appeared in the London Times. That article had strongly implied that the U. S. Government was prepared to take a major initiative at the World Bank-International Monetary Fund meeting, if not before, for greater exchange rate flexibility--specifically, for the so-called "crawling peg." Moreover, the article had suggested that there was solid support for the proposal among the European countries with the exception of Britain. In fact, a poll taken at the dinner revealed that all of the Europeans present were adamantly opposed to the proposal with the exception of Governor Carli, who gave it rather lukewarm support. Both Mr. Robertson and he had declined to comment on the article since it related to a matter being considered at the highest level of the U. S. Government.

Mr. Coombs added that he did not know what further steps might be taken by the Basle group in connection with the subject of exchange rate flexibility. A tentative suggestion had been made for a technical study at the BIS.

By unanimous vote, the System open market transactions in foreign currencies during the period August 12 through September 8, 1969, were approved, ratified, and confirmed.

Mr. Combs then noted that three swap drawings by the Netherlands Bank would reach the end of their first three-month terms soon. These were drawings of $41.1 million, $13.7 million, and $27.4 million, maturing October 2, October 7, and October 10, 1969, respectively. He recommended renewal of all three drawings if the Netherlands Bank so requested, adding that the Netherlands' line had been in active use only since June 12, 1969.

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

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 August 12 through September 3, 1969, and a supplemental report covering the period September 4 through 8, 1969. Copies of both reports have been placed in the files of the Committee.

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

> Money market conditions showed little change in the period since the Committee last met from those prevailing earlier. In the capital market, on the other hand, long-term interest rates pushed sharply higher. The deterioration in the capital market reflected in part supply-demand relationships in various sectors of the market. A growing calendar in the corporate market, large new money demands by Federal credit agencies, the imminence of the Treasury's October 1 refunding, and the twin problems of uncertain tax status and absence of bank demand in the municipal market all contributed to the rise in rates. Market developments also reflected a growing disappointment in the lack of visible progress in the struggle against inflation.
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> The pessimism and cynicism in the market provide a disturbing backdrop to the increased credit demands anticipated from both the private and public sectors over the coming weeks--a period that includes the September tax and dividend dates, the special auction of Alaskan oil leases, a major Treasury refunding, and still further new money needs on the part of the Federal credit agencies. While the near term outlook for

longer-term rates is not bright, the markets in the past have shown great resiliency in maintaining an adequate flow of funds at successively higher interest rate levels. Perhaps a similar performance is in the cards this time, but we should not be complacent about the ability of the financial markets always to rebound during a period of sustained credit restraint. And, as the blue book[1/] notes, any significant evidence of a weaker economy could touch off a sizable investment demand at current rate levels. Towards the end of the month final payments on Alaskan oil leases will provide the State of Alaska with a substantial volume of funds which should lend support to the shorter-term end of the Government securities market.

The municipal bond market, of course, has been a special distress area, with banks largely out of the market and with continuing uncertainties about the outcome of proposed legislation that would reduce the attractiveness of municipals to individual investors. Many issues have had to be cancelled or postponed, and the rate rise of over 1/2 percentage point in the past four weeks was accompanied by a fall in volume of new bond issues to only a little over 50 per cent of the year-ago level, with a similar performance expected for September. So far this year State and local governments have made up part of the shortfall in desired long-term money by short-term borrowing, but with continued pressure on the commercial banks such borrowing has become more expensive and increasingly difficult to arrange. The financial status of some State and local governments is near the critical stage, and little relief appears in sight until the banks can resume more active participation in the market.

While long-term interest rates were rising, most short-term interest rates showed little change on balance over the period, although there was some upward movement in the past few days. There were sizable variations in rates on a day-to-day basis, partly reflecting the Treasury's auction of a $2.1 billion bill strip early in the period. In yesterday's auction average rates

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

of 7.18 and 7.41 per cent were established for three and six-month bills, respectively, up 10 and 13 basis points from the rates established in the auction just preceding the last meeting of the Committee.

As far as open market operations were concerned, a fair amount of flexibility was required to maintain desired conditions in the money market in the face of alternating tendencies towards excessive tautness or ease. While there were day-to-day fluctuations, mainly reflecting the problems banks were having in managing their reserve positions, money market conditions were unchanged on balance from earlier periods.

Over the past several days open market operations have had to contend with a sharp pre-tax-date deterioration of the Treasury's cash position. Not only has the Treasury been forced to run down its normal $1 billion cash balance at the Reserve Banks, but it borrowed $322 million over the week-end and still heavier average borrowing is anticipated until September 17. On balance, we are estimating--and I hope pessimistically--that the Treasury will be supplying about $1-1/4 billion in reserves on average in the current statement week, and $1-1/2 billion next week. This, of course, should be offset by open market operations, but operations were inhibited before the week-end by a money market that was substantially firmer than the reserve outlook would have indicated, and by the reluctance of dealers to take additional bills into their portfolios. Despite operations absorbing reserves on each day so far in the current statement week, we were looking at net borrowed reserves of only about $430 million at the close of business last night. I might add, parenthetically, that in yesterday's auction the Desk redeemed $200 million of maturing bills held in System Account in order to get a start on the reserve absorption that will be necessary in the statement week ahead. While additional action to absorb reserves--perhaps in volume as and if the reserve availability finally shows through in the Federal funds market--will be undertaken today and tomorrow, it is quite possible that we will wind up with a rather shallow level of net borrowed reserves and a very easy money market by late Wednesday.

I am not particularly concerned about a single week's aberration being misinterpreted by the market as an easing of System policy--particularly since the market will know of the Treasury balance position. But I am concerned by the repeated problems the Treasury has had with its cash position over the tax dates in the past year or so. There is certainly nothing wrong with direct Treasury borrowing from the Federal Reserve to meet some unforeseen contingency. That is what the law is for. But a more or less regular pattern of borrowing prior to tax dates only serves to complicate open market operations with the possibility that the short-term Government securities market will be put under unnecessary pressure. It is even more risky when there is a danger that international pressures may require an additional reserve supply from foreign operations. This unhappy coincidence has occurred in the past, and while we have been lucky so far, we will remain exposed to such a recurrence for another week or so. This means, of course, that the Treasury should either be working with a higher average level of cash balances, or should find some way to even out the swings in its cash position which appear to have widened in recent years. We plan to be working with the Treasury with this objective in mind.

The Treasury's more immediate concern, however, is with the refunding of $6.2 billion of October 1 maturities, of which $5.5 billion are in public hands. The size of the maturity pretty well dictates the offer of an anchor and a longer-term issue, and the market is expecting a rights issue with considerable debate over the maturity of the longer-term issue. Given current market uncertainty the Treasury will have to be generous in its pricing, and new high coupons are thus likely. Proposed changes in the capital gains tax affecting commercial banks have added to market uncertainties and could tend to reduce further bank interest in intermediate-term Government securities. There is considerable discussion in the market that the Treasury may have to resort to some special concessions--such as the offer of an issue or issues with a right to convert at some future date to a longer-term security at attractive rates--in order to have a successful refunding. Should the Treasury offer two or more issues, I would plan to split the System's relatively light holding of $336 million of the maturing issue into the anchor and the longer-term issue on the basis of the market's expectations of the likely demand for the issues involved.

As you know, the monetary aggregates generally turned in the relatively weak performance expected of them in August. Some growth is expected in the credit proxy in September, however, under the influence of tax borrowing and the credit demands expected to grow out of the Alaskan oil lease auction tomorrow. The money supply, on the other hand, is expected to contract in a 4 to 7 per cent annual rate range, with the increase in total bank deposits accounted for entirely by a sharp rise in U. S. Government deposits after the tax date.

It is obvious that there has been increased concern about the relative weakness in the monetary aggregates. While the banking and monetary statistics remain difficult to interpret--and financial flows outside the banking system have continued to expand--there is little doubt that a restrictive monetary policy has produced steadily increasing restraint on the banking system. Regulation Q remains the cutting edge of System policy, and it is difficult to see how there can be much improvement in the aggregates--within the context of an over-all restrictive policy stance--unless the relentless CD attrition comes to a halt. Some relaxation of Regulation Q may thus be a prerequisite for the resumption of a moderate growth of bank credit and the monetary aggregates. Any change in Regulation Q, however, runs the risk of being interpreted as more of a move towards ease than the Committee might desire. It would of course be desirable that a relaxation of Regulation Q avoid any massive rebuilding of CD's such as occurred in the second half of 1968 or a competitive upward-ratcheting of short-term interest rates. But it is not easy to see how a controlled, modest rebuilding of bank CD's can be readily accomplished.

Earlier I referred to the Treasury's cash balance problem. As the Committee knows, within the $5 billion legal limit on direct Treasury borrowing from the Reserve Banks, paragraph 2 of the continuing authority directive presently authorizes the Federal Reserve Bank of New York to lend up to $1 billion directly to the Treasury. Since our current estimates indicate that Treasury borrowings may come perilously close to that limit by September 15, I would recommend that the Committee temporarily increase this authorization to $1.5 billion to be on the safe side. Specifically, I would recommend that the Committee amend paragraph 2 of the continuing authority directive by raising the limit on Federal Reserve Bank holdings of special short-term certificates purchased directly from the Treasury from $1.0 billion to $1.5 billion, on the understanding that the limit will revert to $1 billion at the close of business on the day of the Committee's next scheduled meeting.

Mr. Hickman asked whether in Mr. Holmes' opinion a reversal of the recent behavior of the monetary aggregates might be achieved through a slightly less restrictive monetary policy. He (Mr. Hickman) did not see why it should be necessary to raise CD ceiling rates and thereby cause the whole structure of interest rates to ratchet up in order to affect those aggregates.

Mr. Holmes replied that an easier monetary policy, if the Committee wanted to move in that direction, could produce the same result as higher CD rates. The point he wanted to make was that until CD rates became more competitive, banks were likely to continue losing CD's.

Mr. Hayes observed that a sizable downward movement in market interest rates would be needed to make CD's competitive under current CD rate ceilings.

Mr. Hickman indicated that in his view a marginal decline in market interest rates--involving perhaps a reduction in the three-month bill rate to somewhat below 7 per cent--would help to moderate the contractive tendencies in the monetary aggregates. He felt that the Committee had allowed monetary conditions to get too tight in recent months.

Mr. Morris expressed the view that the Treasury was abusing its authority to borrow on an emergency basis from the Federal Reserve. The Treasury had been running its cash balance at too low a level to provide a margin for contingencies and its frequent borrowings from the System were a threat to the effective implementation of System policy. If the Committee shared his concern, he thought it might be desirable to inform the Treasury of the difficulties created for the Manager by the low cash balance.

Chairman Martin indicated that he had raised the matter with Secretary Kennedy yesterday and that Mr. Kennedy shared the concern about the low balance. Numerous considerations were involved in the management of the Treasury's cash position and the problems had been compounded recently by difficulties encountered in projecting the balance. The Treasury needed a larger balance, but it was not a simple matter to increase it under current circumstances. Since the Treasury was aware of the problem he questioned whether it was necessary to discuss it in a formal communication, but that course might be considered if there was sentiment for it.

Mr. Maisel said it was not clear to him whether the problem was created by the size of the Treasury cash balance or by difficulties encountered in its administration.

Mr. Holmes indicated that the Treasury was making maximum calls on all its available cash in the commercial banks and was speeding up its call schedules wherever possible. However, under present administrative regulations some of the Treasury's deposits in the smaller banks could not be drawn upon until an advance notice had been given and as a result the Treasury could not make immediate use of all the deposits in its accounts on a particular day.

Mr. Brimmer said it was his impression that pressures were being exerted on the Treasury to maintain deposits in small banks that were providing funds in support of special programs such as loans to small businesses. He did not think it was necessary for the Committee to send a formal letter to the Treasury since Secretary Kennedy was already aware of the concern among System officials and Mr. Holmes was planning to look into possible remedies with Treasury officials.

However, he (Mr. Brimmer) hoped that the study of the Treasury cash balance problem would give some attention to the related issue of unavailable Treasury balances in small banks.

Mr. Holmes observed that one approach toward resolving the Treasury's cash management problem would be to work out a temporary means of financing large cash drains. For example, the Treasury might auction bills with maturities of a few weeks.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 12 through September 8, 1969, were approved, ratified, and confirmed.

Chairman Martin noted that Mr. Holmes had recommended a temporary increase from $1.0 billion to $1.5 billion in the authorization for direct loans to the Treasury by the Federal Reserve Bank of New York. However, information just received indicated that the Treasury cash position this morning was worse than had been projected. It might therefore be safer to raise the authorization temporarily to $2 billion even though the odds were that the Treasury would not need the entire additional amount.

Mr. Holmes concurred. He added that the larger increase might preclude the need for an interim action by the Committee before the next meeting.

By unanimous vote, the dollar limit specified in paragraph 2 of the continuing authority directive, on Federal Reserve Bank holdings of short-term certificates of indebtedness purchased directly from the Treasury, was increased from $1 billion to $2 billion, with the understanding that the limit would revert to $1 billion at the close of business on October 7, 1969, unless otherwise decided by the Committee on or before that date. As amended, paragraph 2 read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury for the account of the Federal Reserve Bank of New York (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $2 billion.

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

Mr. Gramley made the following statement concerning economic developments:

The over-all contours of the Board staff's GNP projection for the period between now and mid-1970 have not changed much from the initial presentation in the chart show at the June 24 meeting of the Committee. At that time, we were projecting a slowdown in final sales in the third and fourth quarters of this year, triggering an inventory correction in the first half of 1970. We still are.

Though the projection has not changed much, the probabilities that I would assign to the expected slowdown have. In late June, the projection of moderation in economic expansion seemed to us the most likely course of events, but it was perhaps less than an even bet at that time. Enough evidence has come in during this past summer, however, to raise materially the odds on this outcome.

The most solid evidence that aggregate demands are beginning to lose some of their steam comes from the recent indicators of employment and production. In July and August, nonfarm employment gains averaged only about 70,000--and even less, if the August change is corrected for poor seasonal adjustments of employment in the auto industry. This compares with an average monthly rise of 200,000 in the second quarter and 300,000 in the first. Employment in construction and in the Federal sector declined in each of the past two months, and we have begun to see more moderate demands for labor in most areas of manufacturing other than capital goods production. Hours worked in manufacturing also edged off a little in August. Over all, labor markets are still tight--as the slight decline in the unemployment rate to 3-1/2 per cent during August indicates. But the employment data are more reliable indicators than the unemployment rate of short-run changes in demand for labor, and these data have been showing much less strength since mid-year.

On the production side, we now know that the July increase is smaller than it seemed a few weeks ago. With the downward revision of manufacturing employment data--both numbers and hours--for July, the production index for that month will be revised down substantially. And with the index in August now expected to show a smaller increase than the revised July gain, growth in industrial output over the past two months seems to be working out to an annual rate of about 4 per cent or perhaps less--compared with 6 per cent in the first half of the year.

This moderation in output during the third quarter seems to be reflecting, as best we can estimate, a slower rate of expansion in private final sales--with declining residential construction the principal source. Consumer spending has also continued relatively sluggish, however, with unit sales of domestic autos in July and August off by about 10 per cent from the second quarter. Meanwhile, Federal outlays in the third quarter rose no more than the amount of the pay raise. Despite this slowing in final sales businesses do not yet seem excessively concerned that their inventories are out of line with sales, but it seems likely that they soon will be if growth in final sales does not accelerate.

As I would interpret the information that has become available recently, however, declines in two major areas of final demand, Federal purchases and residential construction, are now more probable--and very likely larger, also--than we thought two months ago. In the light of additional announced cutbacks in defense spending, the rise in new orders for defense goods in July does not appear to be more than an erratic movement in a volatile series. Substantial reductions in defense purchases will be required in the period ahead to stay within budgeted limits. The recent curtailment of new contracts for Federal construction, furthermore, will help to insure that total Federal purchases keep moving down during the remainder of fiscal 1970.

For housing starts and residential construction, the outlook seems to have become a good deal more bleak in the past couple of months, in reflection of the cumulative effects of monetary restraint on all of the major institutional mortgage lenders--the commercial banks, the nonbank thrift institutions, and the life insurance companies. We have, accordingly, been revising our projections downward, but perhaps not far enough. We will have a better idea as to what is happening in the housing field after next week's mortgage market survey. But I would be surprised if that survey does not show a substantial deterioration in lender attitudes to commit funds, and in mortgage credit availability during recent months.

For business fixed investment, the evidence from the recent Commerce-SEC and McGraw-Hill surveys is hard to interpret. As in the past several surveys actual plant and equipment expenditures for the quarter just ended were revised down substantially, while the expected increase in outlays in the current quarter were revised up, but by a smaller amount. There are various factors that could explain the emerging pattern of revisions in business spending plans this year, as the green book[1/] indicated, and we do not know which is the most important. What we do know is that the level of spending has tended to fall short of earlier anticipations, and we have no reason to expect a departure from that pattern over the next several quarters. This, together with the leveling out of new orders for machinery and equipment since about February, make the green book projection of business fixed investment seem quite reasonable.

Third-quarter developments, then, portray an economy in which real growth has slowed a little further, imbalances between final sales and inventories are becoming more noticeable, and key areas of final demand show relatively clear signs of weakness--at least as clear as a forecaster can reasonably hope for. Probable economic developments thus seem to me less uncertain now than they were a couple of months ago--and, accordingly, the probability I would assign to the general course of cyclical developments described in the Board staff projection is now considerably higher.

In deciding what course of monetary policy would be appropriate in light of these projected economic developments, however, there is still lots of room for differences of opinion. As the Committee is well aware, there clearly are risks involved in backing off too early from the current posture of monetary restraint, as well as risks of overstaying.

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

> Inflationary expectations are still quite strong in the business community, and they have been with us for some time. Price developments in the third quarter have not helped much in this respect--given the price advances for metals and other materials, and the further rise in prices of producers' equipment. But if my assessment of the economic outlook is correct, then I think it follows that the risks have increased markedly in the past couple of months that the current policy of severe monetary restraint will be overdone and will produce a degree of economic weakness considerably greater than that projected--weakness to a degree that will require a marked shift in policy toward ease at some point down the road.
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> Given the forthcoming Treasury financing, the Committee may well wish to avoid any overt actions or, indeed, any significant change in the posture of monetary policy over the next few weeks. But I feel that the time for backing off from the present degree of monetary restraint cannot be postponed much longer if we are to avoid a recession beginning early next year.

In response to a question by Mr. Morris, Mr. Gramley indicated that the monetary policy assumption incorporated in the green book projections implied some backing off from the current degree of monetary restraint early in the fourth quarter.

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

> The recent interest rate increases in all sectors of the capital market seem to me to suggest that the effects of the monetary policy course set last December are continuing to cumulate--indeed are taking effect over a widening arc. It may be that some of the interest rate rise also represents a weakening of confidence in the likelihood of near-term success for fiscal and monetary policies in containing inflation.

But I would be surprised if any such weakening of confidence, to the extent that it has developed, were long lasting under current economic and financial conditions.

What we are now seeing in capital markets is traceable, fundamentally, to the further erosion of the more usual institutional sources of credit, with borrowers consequently having to shift to noninstitutional sources of funds--a development that has traditionally exerted upward pressure on longer-term interest rates. Shifts away from institutional borrowing appear to have been accentuated during the past couple of months as deposit flows into banks, savings flows into thrift institutions, and the availability of investible funds at insurance companies have been further constrained.

It appears that we may be in the middle of a quantum change for the worse in the position of thrift institutions. After net savings inflows at an annual rate of 6 per cent or a little better for five successive quarters through the first quarter of 1969, net savings inflows dropped to under 4 per cent in the second quarter of 1969 and are likely to drop further in the current quarter. This significant deterioration in thrift institutions' position, and given further erosion of funds flows at commercial banks and life insurance companies, has led to further cutbacks in the availability of mortgage commitments from institutional sources. As a result, Federal agencies have come increasingly to the support of the mortgage market, and these agencies have, in turn, gone to the open market for their financing, with an exceptionally large volume of offerings already marketed or in prospect for the current half year.

At the same time, pressures on the State and local government area have also been intensified. Uncertainties about the future tax status of municipal issues have, it is true, been an influence. But the cumulating pressures on banks have also led to a very sharp reduction in bank holdings of State and local government securities since mid-year. During the past two months all commercial banks have reduced holdings of these and Federal agency securities combined by about $900 million per month, as compared with only a small net reduction in such holdings in the second quarter.

The further withdrawal of the banking system from the municipal market has developed partly because monetary restraint has now spread beyond large money center banks and is having significant effects on the lending and investing policies of medium-sized and smaller banks throughout the country. Attrition of negotiable CD's and the continued weakness of consumer-type time and savings deposit flows has recently been hitting these banks relatively more, as the most interest-sensitive domestic funds have already been largely drained from the large money center banks. As the focus of time deposit weakness shifts more to banks outside the major money markets, mortgage and State and local government security markets are likely to remain under pressure, since these banks have less access to other sources of funds--such as Euro-dollars or commercial paper--that would enable them to moderate the effects of time deposit weakness.

I do not mean to be implying that the position of major money center banks is not very tight; it is quite tight. Indeed, the tightness of their position, combined with the worsening situation of banks outside New York, may be one factor contributing to the very recent rise in corporate bond offerings--some of which, according to market reports, result from pressure to repay or avoid bank loans. Nevertheless, it is possible that pressure on sources of funds to money center banks may moderate under existing regulatory provisions, since their remaining negotiable CD's are now very small relative to their total assets and seem to be declining at a somewhat slower pace than earlier this year.

In early December 1968, when outstanding CD's of New York banks, for example, were at their peak of $7-1/2 billion, they represented 10 per cent of total assets of these banks. At present, these banks have only about $2 billion of CD's left; and these finance only about 2-3/4 per cent of total assets. It is interesting to note that the compensating build-up in Euro-dollar borrowings has brought such liabilities of New York banks to a total now of over $10-1/2 billion, representing a little more than 13-1/2 per cent of their total assets--a doubling since December.

Taking account of recent financial developments, and given the economic outlook as described by Mr. Gramley, it would seem to me desirable, at a minimum, to conduct open market operations over the next four weeks in such a way that some of the edge is taken off market tightness. The recent performance of monetary aggregates tends to buttress that conclusion, although some improvement, quite possibly temporary, for some aggregates is projected for September. While I do not believe that monetary aggregates in themselves are an adequate guide to policy, it is somewhat foreboding that significantly slower rates of increase or greater rates of decline have developed for all monetary aggregates over the past two months--a development that has undoubtedly contributed to upward interest rate pressures.

That there will soon be a sizable Treasury exchange in the market need not be, in my view, an impediment to taking the edge off market tightness. While I do not have time here to spell out the analysis, it seems to me that the constraint of "even keel" may have been somewhat overemphasized in the past, particularly given that open market policy is generally shifted gradually and given that the market recognizes that its business is to take the risk of evaluating the future. Thus, if some slight easing of money market conditions from recent ranges were needed to moderate credit market pressures, the Treasury financing need not be a roadblock. And I would make the same argument if some slight tightening appeared desirable--always recognizing, though, that the time between annoucement and close of books is a period when operations have to be especially sensitive to a financing.

If the Committee wished to move somewhat in the direction of moderating recent tightness, it might consider eliminating the word "firm" from the phrase "prevailing firm conditions" in the proposed directive.1/ This would permit some little easing of the money markets in light of over-all credit conditions and would provide more flexibility for attempting to fend off weakness in monetary aggregates. But such a view would be most accurately reflected in a second paragraph which directed the Manager "to maintain about the prevailing conditions in money and short-term credit markets, while taking account of monetary flows and also the Treasuring financing."

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

Mr. Morris observed that in light of Mr. Axilrod's analysis he found it difficult to understand the blue book projection of essentially no change in time deposits in September.

Mr. Axilrod replied that two factors had influenced the projection for September and he would expect renewed weakness in October. The first factor affecting the September projection was that, because of interest rate relationships, corporations had not built up their holdings of CD's maturing in September--a month of quarterly corporate tax and dividend payments--as much as they usually did, with the result that a smaller net run-off was implied than in other recent months, after allowing for seasonal adjustment. The second factor related to the pattern of flows of consumer-type time deposits during recent quarters when monetary conditions had been tight. Such deposits typically flowed out of banks during the first or interest-crediting month of the quarter; the flows tended to improve in the second month; and net inflows were characteristic of the final month. The blue book projection assumed a continuation of such a pattern in the current quarter.

In response to a question by Mr. Brimmer, Mr. Axilrod indicated that the second of his two suggestions for the directive--which would call for maintaining "about" the prevailing conditions in the money and short-term credit markets--was intended to provide the Manager with more flexibility since such conditions had fluctuated widely during the last several weeks. That language had to be read in conjunction with his proposed rewording of the proviso clause, which he hoped would convey the notion that the Manager should give somewhat more weight to flows and only secondary weight to the Treasury refunding before deciding on a possible implementation of the proviso.

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

> With the franc devaluation behind us and both the German election and the Fund and Bank meetings ahead, it may be useful to take a look at the strength of the dollar, present and future, and to ask what implications, if any, one can draw for future policies of the United States.
>
> In contrast with the British devaluation of November 1967, the franc devaluation seems to have had no unsettling effect on the confidence in the dollar. Yet, the underlying U. S. balance of payments position appears worse now than it was in late 1967. Our surplus on goods and services in the second quarter of this year was at an annual rate of only about $1 billion, compared with about $4 billion in the fourth quarter of 1967.
>
> What accounts for the difference in reaction to the two devaluations?
>
> First, the French currency is much less important internationally than sterling. Second, the world has learned that the parity of a major currency can be changed without necessarily bringing on an immediate chain reaction; in this case the way for the French move was paved by multilateral consideration at the Bonn Conference last November. Third, even though the underlying balance of payments of the United States is quite unfavorable, the immediate payments position has been strong, thanks to the pull of tight money here.

Thus, whereas there was an increase of $3-1/2 billion in U. S. dollar liabilities to foreign monetary authorities in the year 1967, such liabilities fell by $2-1/2 billion in the first half of this year. Foreign monetary authorities, with a few notable exceptions, do not feel that they have been flooded with unwanted dollars recently. As a matter of fact, total U. S. liabilities to foreign official holders are lower now than they were at the end of 1964--almost five years ago.

When we say that confidence in the dollar has been maintained despite the French devaluation what we mean is that no foreign monetary authorities have rushed in to buy gold from the United States and the free market price of gold has not been bid up by private speculators. It is fair to say that as a result of the success of the two-tier system and of the imminent activation of Special Drawing Rights, confidence in the $35 official price of gold has been greatly strengthened in the past year and a half.

Some satisfaction can be taken from this state of affairs. Nevertheless, there is hardly cause for optimism as we look ahead. The prospects for the U. S. trade balance are unpromising. After the cooling off of the economy finally begins to dampen U. S. imports, we may soon face an early cessation of the remarkable boom in Europe and Japan, which will certainly hurt our exports.

But apart from these cyclical influences on our trade balance, there is increasing evidence that our competitive position is feeling the effects of the inflation of the past four years. Meanwhile, Germany and Japan have very large surpluses in their trade balances despite boom conditions in their domestic economies.

When one adds to the unfavorable prospect for our trade balance the strong desire of the Administration to relax the Commerce Department and Federal Reserve foreign credit restraint programs and also the potential for short-term capital outflows--with Euro-dollar liabilities at $15 billion--it is easy enough to imagine serious trouble for the dollar in the next year or two.

What is one to conclude from this record of recent and current strength but potential future weakness in the U. S. payments position? For the

Federal Reserve itself there is the obvious conclusion that ending the inflation is important for balance of payments reasons as well as domestic reasons. Furthermore, as I suggested at the Committee's last meeting, a policy of steady monetary restraint would be more favorable to the capital accounts of the balance of payments than excessive tightness followed by active ease. But ending inflation, while necessary, is probably not a sufficient condition for keeping the dollar strong in the period ahead. The bleak prospects for our trade balance, coupled with the overhang of short-term liabilities to the Euro-dollar market, lend an element of urgent self-interest to the question whether the United States should encourage a system of greater flexibility of exchange rates--not only because such a system might improve the operation of the international monetary system but also because it may be the only way to restore the U. S. competitive position.

If we could count on a sizable one-time revaluation of the German mark and of currencies of other countries with a strong balance of payments, perhaps that would be enough to restore our competitive position. But from every indication we have, even if Germany agrees to revalue some time after the September 28 election, the amount of the effective revaluation would be rather small. In the absence of adequate revaluations by surplus countries, imbalances are all too likely to be corrected over time by devaluations of deficit countries. The consequence would be that in time the position of the dollar would look untenable and the viability of the present gold price would once again be questioned.

One way--perhaps the only feasible way--to avoid this unfortunate outcome is to strive for some greater flexibility of exchange rates. If international agreement could be reached on greater flexibility of exchange rates--in terms of small but frequent adjustments upward, as suggested by some Europeans, and possibly both up and down--it might be easier for Germany and other surplus countries to effect over time a sufficiently large appreciation of their currencies against the dollar to improve the U. S. competitive position. This doesn't necessarily mean an automatic crawling peg tied to market rates. That particular system may not be practical or negotiable. But it is possible to envisage a system in which small and frequent exchange rate adjustments would be made, based on internationally-agreed criteria and rules of the game in the IMF.

What is mainly needed is a negotiated understanding on exchange rate policy that would at least to some extent take the subject out of the political arena. If limited changes in exchange rates could be carried out in somewhat the same technical way that central bank discount rates are changed, the world would have a better balance of payments adjustment process and the United States would have a more favorable outlook for its balance of payments.

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

As we meet today, nearly nine months have passed since the System moved to a policy of firm monetary restraint, and about fifteen months since adoption of the fiscal program which was counted on to play a major role in cooling the overheated economy. Despite the difficulty of interpreting recent credit and money statistics, it is clear that System policies, applied over many months, have produced a cumulative tightening of pressures on the banking system and a visible slowing of the growth rates of all the major monetary and credit aggregates. Yet when we turn to the statistics on the economy, we find virtually no evidence of meaningful progress in bringing inflation under control. In view of the customary lags, perhaps we should not feel too discouraged by the fact that prices and wages are still rising about as fast as ever. But what I do find very disturbing is the lack of evidence that we are even close to a sufficient slowing of aggregate spending to start making a dent in this price and wage trend.

Although the business indicators continue to show a mixed pattern, on balance they point to further real expansion and sizable price inflation over the coming months. Of course a major slowing of growth later this year and early next year cannot be ruled out, but I think the odds are against it. Housing is the only conspicuously weak sector of the economy. Inventories remain in a generally reasonable relationship with sales. Revisions in the second-quarter GNP data tend to support an impression of a comfortable inventory position and reasonably strong consumer spending. The recent spate of fresh readings on business capital spending plans suggests that while the uptrend in such spending is likely to prove more modest than earlier surveys had indicated, the rise may well continue longer than had been earlier expected--probably remaining a stimulative factor in the economy well into 1970.

The international scene is as discouraging as the domestic. While the dollar has remained strong in the exchange markets, the international financial situation is delicate, to say the least, and another severe exchange crisis could place the dollar in jeopardy. In stressing this danger I have in mind, of course, the evidence of serious deterioration in our basic balance of payments position, after ample allowance for the heavy capital outflows this year resulting from speculation on a German mark revaluation and from the pull of high Euro-dollar rates on U.S. corporate funds.

Against this alarming background how should we view the recent credit and monetary statistics? On the one hand, it could be argued that since the growth of the major aggregates has slowed materially, and since this could well lead, after sufficient time has elapsed, to a major slowing of the economy, we should now be thinking in terms of a start toward reducing the current degree of monetary restraint. But such a conclusion, I believe, would imply far too much confidence in our ability to pinpoint the consequences of our actions, both as to extent and as to timing. I note also that Congressional approval of the extension of the income tax surcharge is still uncertain. I therefore believe we must continue to be guided more by tangible evidence of an adequate slowing of economic growth than by what we hope may happen a good many months from now. And, as I have already indicated, what we see right now is an economy still strongly dominated by expectations of rapidly rising wages and prices, despite the weak stock market and despite a few comparatively weak business statistics.

To put it another way, it seems much less risky to let the financial aggregates continue to grow at somewhat below a desirable long-term rate than to let up on the brakes and thereby court an even stronger upward thrust of prices and wages than we now face. I also find strong support for this view in the fact that conventional credit data are peculiarly suspect at the moment because of the proliferation of the banks' nondeposit liabilities, the development of escape routes by banks' disposal of assets to affiliates, and, more broadly, the recent burgeoning of various forms of nonbank credit, including commercial paper. It seems to me, therefore, that open market policy should continue unchanged, on purely economic grounds, as well as because of the even-keel consideration arising from the large prospective Treasury refunding. The target ranges discussed at the last FOMC meeting remain appropriate, i.e., a Federal funds rate of 8-1/2 to 9-1/2 per cent, borrowings of $1 to $1-1/2 billion, net borrowed reserves of $1 to $1.3 billion, and a bill rate around 6.90 to 7.25 per cent. I would still retain the proviso in the directive, although the ambiguities in current data suggest that the Manager should continue to have ample leeway in the interpretation of whatever proviso we may adopt.

We all recognize that there are risks that the cumulative pressure of restraint can undermine the functioning of financial markets. At present the bond markets are quite shaky, in part because of the same disappointment over the persistent strength of inflationary forces that bothers so many of us. We cannot let the possibility of further deterioration of the capital markets deter us from maintaining a restrictive policy, but I think it would be prudent to reaffirm that the Manager has full authority to deal with any market situation that threatens to turn disorderly.

I have read with interest Mr. Mitchell's memorandum on the proviso.[1/] I agree that the usefulness of the bank credit proxy has been impaired in recent months. However, I am very doubtful about any precipitous adoption of a "monetary aggregate" criterion that involves five or more different variables, all suffering in one degree or another from the same disease as the credit proxy. I can readily see how the adoption of the monetary aggregate approach would be interpreted by the public and the press as a major shift towards a monetarist position--an outcome I would consider

1/ This memorandum, dated September 5, 1969, was entitled "Proposed alternative to use of bank credit in proviso clause." A copy has been placed in the Committee's files.

> highly undesirable. I am much less sure how a proviso involving so many variables would work in practice either for us or for the Manager. I would prefer to stick with the present approach pending some more detailed clarification, based perhaps on past performance, of how the constellation might perform. I obviously prefer draft alternative A.
>
> At the last meeting I suggested that the time was close when it might be well for the Board to consider some modification of the Regulation Q ceilings in view of the multiple important distortions, both at home and abroad, attributable to these ceilings. In the present delicate international situation, in which very high Euro-dollar rates are contributing significantly to the weakness of several European currencies, this goal seems especially worthwhile. I would not advocate a change in the ceilings before the Treasury has carried out its prospective refunding. But after that is out of the way I do believe something should be done to correct these distortions, even at the price of some increase in domestic interest rates and even at the rather paradoxical risk of seeming to move to reduce credit restraint. A discount rate increase might be held in reserve as a possible later move if the modification of the ceilings were to be misinterpreted as a significant policy move toward less monetary restraint. In any event the next few weeks, while the Treasury financing is in progress, should provide an opportunity for careful review of this subject.

Mr. Francis remarked that although total spending for goods and services continued to rise and inflationary pressures were strong, it appeared to him that the degree of monetary restraint in the past eight months had on average been appropriate. The Committee had to be patient until the effects of its past actions had had time to manifest themselves. In fact, care had to be taken that it did not now become too restrictive, either intentionally because of impatience with the results achieved so far, or unintentionally because money market conditions provided misleading indications of monetary actions and influence.

Mr. Francis said the new money stock data, revised to eliminate the understatement of net demand deposits caused by so-called "London checks," showed very much the same pattern of monetary action as did the old series. Using the revised series, it appeared that the rate of growth of money had decelerated at the beginning of 1969 in response to the System's changed policy in December. From December to early June, the increase was at a 4 per cent annual rate compared with 7 per cent in 1968. Since early June money had grown at less than a 1 per cent rate. That record seemed to indicate appropriate action on the whole in view of the strong inflationary expectations. A table in the blue book[1/] showed the intensified restriction for all major monetary magnitudes since June. The data seemed to indicate that the Committee might have been insufficiently restrictive in the first half of the year

1/ The blue book table referred to summarized recent annual rates of change in major deposit and reserve aggregates as follows:

	July '68-Dec. '68	Jan. '69-June '69	July '69-Aug. '69
Total reserves	10.9	-0.7	-14.5
Nonborrowed reserves	11.0	-3.7	-11.6
Bank credit, as indicated by:			
Proxy	13.4	-3.5	-14.7
Proxy plus Euro-dollars	13.5	--	-10.4
Total loans and investments (as of last Wednesday of month)	15.0	3.0	--
Money Supply	6.8	3.8	0.3
Time and savings deposits	16.1	-5.0	-17.8
Savings accounts at thrift institutions	6.4	4.9	- 0.2 (July)

and too restrictive this summer. But that was water over the dam and the Committee's problem was what to do for the future.

Past experience indicated, Mr. Francis continued, that once the slowing of growth of monetary aggregates had begun, there was a danger that monetary action would inadvertently become progressively more restrictive. Effective monetary restraint reduced spending and credit demands. With the System's emphasis on judging policy in terms of money market conditions, the influence of reduced demand for funds on measures of money market conditions might be overlooked and the growth rates in monetary aggregates might be reduced further.

Mr. Francis thought there was evidence that a cumulative tightening process was already taking place. Even though monetary policy and the day-to-day guides used by the Manager had remained about unchanged in recent months, an outline of progressively more restrictive monetary developments seemed to be emerging. Business loans at large banks, which rose at a 13 per cent annual rate from December to May, had gone up at only a 3 per cent rate since May. Interest rates generally, which were rising markedly earlier in the year, appeared on the whole to have leveled off in the past two months. Total member bank reserves had declined at a 13 per cent annual rate in the last three months, following little change from January to May. Money, after rising at a 4 per cent annual rate from December to early June, had increased at less than a 1 per cent rate since early June, and the staff had projected a 5 per cent rate of decline during September.

Mr. Francis commented that the Committee, of course, wanted restraint on total spending, and the recent intensification of monetary restraint might have been desirable; but it did not want the process to accelerate and become too severe. If declines occurred in the demands for credit, and as a result interest rates declined, the System should not interfere with that process. In his opinion, the System was more likely to achieve its desired results if it permitted interest rates to be determined in the market and focused on providing appropriate amounts of Federal Reserve credit, bank reserves, monetary base, and money. He commended Mr. Mitchell's memorandum proposing the elimination of bank credit as the sole variable in the proviso clause, and like Mr. Mitchell, he preferred issuing a directive in terms of M_1, rather than a constellation of aggregates which in his view did not remove the traditional vagueness of the policy target.

Mr. Francis suggested that in the near future the proximate objective of policy be an increase in the money supply at about a 2 per cent annual rate, while allowing interest rates to fluctuate as demands and supplies of credit funds changed. Because of even keel considerations, wide interest rate movements might be moderated in the next four weeks, but extreme care should be taken not to peg interest rates by continuously withdrawing reserves and thereby causing further reductions in the rates of growth in monetary aggregates.

In Mr. Francis' view, both alternatives for the policy directive were too restrictive, since the proviso clauses were based on current projections which were consistent with a decline in total reserves at a 4.8 per cent annual rate during September, a decline in private demand deposits at a 9.5 per cent rate, and a decline in money at a 5 per cent rate. He felt that such results would not maintain the present level of restraint but would vastly increase it.

Mr. Kimbrel said he would first comment on a recent decidedly unwelcome visitor to the Sixth District--Hurricane Camille--which had been described as the worst hurricane ever to strike the Western Hemisphere. It had struck with full force in the Biloxi-Gulfport area of Mississippi. Last Friday he had visited the area and had found conditions almost impossible to describe. A relatively new bank building had only the concrete slab and the vault left. A number of bank buildings had lost all of their upper stories. Between 1-1/4 and 1-1/2 million acres of timber were reported to be damaged. About one of every five homes in the area was either completely destroyed or considerably damaged. Gulfport's harbor was rendered completely useless and three ships were left on dry land. Tourist facilities were reduced to rubble. At least 70 individuals were still not accounted for.

Mr. Kimbrel observed that some aspects of the aftermath of the hurricane were evident in his visit. A conversation he had been holding with the chief executive officer of a bank had been interrupted by a call from the mayor who inquired about a loan of $800,000 to finance repairs and clean-up operations. Municipal and State authorities were concerned about the effect on revenues of the increase in tax deductions and the reduction in the tax base that would result from the destruction of property. They were hoping for substantial Federal financial assistance. There also was concern about the possibility of massive dropouts from college this fall. He could report, however, that he had found the morale of the people in the area to be extraordinarily high. They were determined to bounce back, and were hoping to carry out the restoration in a way that would result in a model area.

Turning to the general economic situation, Mr. Kimbrel reported that on balance there seemed to be a little more evidence available today than at the previous meeting that the reduction in inflationary pressures the Committee was trying to achieve might at last be taking hold. But the experience seemed to be that, just as the Committee began to get encouraged by one set of recently released statistics, another set became available that seemed to suggest that monetary policy was not taking hold after all. Consequently, he supposed his attitude could be characterized as one of doubting optimism.

Such seemed to be the case in the Sixth District, Mr. Kimbrel observed. Industrial employment failed to increase in July, and consumer spending indicators were less vigorous than they had been. Bank lending had moderated. A tabulation of proposed expenditures announced in the second quarter for new and expanded manufacturing plants in the Sixth District showed the dollar volume down sharply and forecasted a future decline in capital expenditures in the District. On the other hand, there was a sharp increase in construction contracts for July, and construction employment increased. For the first seven months of 1969, construction contracts in the District were running 20 per cent ahead of the corresponding period last year. Moreover, to the extent that financing became available, an upsurge should be expected in construction in the hurricane-damaged areas of the District.

For the present, Mr. Kimbrel continued, it would seem wisest for the Committee to try to stand pat for a while. There did not seem to be a case for tightening further, but neither did it appear that the time had come to move toward ease. Moreover, the Treasury refunding operation probably precluded any policy change.

Past experience suggested to Mr. Kimbrel that, despite the best of intentions, the Committee sometimes found that in attempting to stay where it was in terms of the money market variables it ended up being more or less restrictive than it intended in terms of making credit available. The inclusion of the proviso clause in the directive, therefore, had helped to avoid that kind of a situation. As a matter of fact, he had sometimes felt that it might have been better to have stated the directive in quantitative terms and the proviso in terms of money market conditions.

It was quite possible, it seemed to Mr. Kimbrel, that the kind of quantitative specification to be used could differ from time to time and had to be chosen on the basis of pragmatic testing. Therefore, he had some sympathy with what he believed Mr. Mitchell was proposing in his memorandum. He (Mr. Mitchell) was suggesting, Mr. Kimbrel believed, that the credit proxy, no matter how well it had served the Committee in the past, had gotten out of phase. Therefore, the Committee had to find a better quantitative tool. What he was a little worried about, however, was that monetary aggregates, in a broad context, were just about as broad as the term "money market conditions." If the Committee were to substitute the words "monetary aggregates" for "bank credit" in the directive, careful specifications as to what those variables were would have to be made at each meeting. For the present, if he had to choose, he would go along with alternative A of the draft directives.

Mr. Bopp commented that signs of a slowdown lasting at least into early 1970 now seemed reasonably clear. Growth of business loans was off; construction was depressed; and, if the stock market was forecasting correctly, the outlook for corporate profits was poor. In short, although business conditions were still good, the upward momentum of the economy that business had taken for granted in recent years was petering out.

Developments in financial markets seemed to Mr. Bopp also to be proceeding as the Committee had sought. In Philadelphia, commercial banks reported they were planning additional measures for rationing funds. One bank had gone so far as to require that every loan over $10,000 be approved by one of four senior officers. The problems facing Philadelphia banks were compounded by the need for funds by the school system which they felt a moral obligation to supply. In addition, upcoming corporate tax dates would place further pressure on them. The overhang of loan commitments was still a potential source of trouble.

But, Mr. Bopp said, in spite of spreading signs of a slowdown and in spite of the escalation of bank rates since the beginning of the year, demand for bank credit was still strong. One of the largest Philadelphia banks expected loan demand to increase in the fourth quarter and to rise still further in the first quarter of 1970. That was just one indication that the economy still possessed considerable underlying strength and that inflationary pressures were still very much alive.

Perhaps more disquieting was what seemed to Mr. Bopp to be a widespread opinion that the long awaited cool-down in the economy would be over by mid-1970 and that the inflationary build-up would resume. And that opinion was by no means restricted to the unsophisticated and the uninformed. A number of forecasts which he had seen recently called for a strong resurgence of aggregate demand by mid-1970. Those kinds of forecasts were what was causing more and more observers to consider the imposition of direct controls.

Both because of strength of the economy in the near-term and because of widely held expectations about next year, Mr. Bopp was persuaded that the time was not yet appropriate for an overt move to ease. In the face of a continuing credibility gap about the policy makers' ability to contain inflation, it was extremely important that belief in the efficacy of monetary policy not be cast in further doubt. Since the end of last year, the System had succeeded in changing the expectations of a few. It was important that it change the expectations of many more.

But in view of the imminent slowdown in the economy and the policy stance so far this year, Mr. Bopp saw no need now for a policy of greater restraint. He, therefore, would vote for a policy of no change. He was sympathetic with Mr. Mitchell's memorandum but thought it might be more appropriate to defer a decision on the matter until Mr. Maisel's committee on the directive had had an opportunity to report.

Mr. Hickman commented that evidence of a slowdown in real economic activity continued to accumulate, but so far there had been little abatement in the upward movement of prices. The reduction in activity during the first half of 1969 centered in residential construction, defense spending, and retail sales. The Board's informal survey of capital appropriations and the McGraw-Hill and Commerce-SEC surveys of capital expenditures all indicated that plant and equipment expenditures had been scaled down for 1969 and would provide less thrust to activity over the next six to nine months. The recently announced cutback in Federal construction expenditures presumably would reinforce those downward adjustments. The failure of prices to respond to monetary restraint was inherent in the relationships and timing of economic events: prices were still rising because of inappropriate monetary and fiscal policies in the past, but would eventually level out if restraint was maintained over a sufficiently long period of time.

Mr. Hickman noted that for the past several meetings he had expressed the view that current monetary policy was excessively restrictive and would lead to an unacceptably low level of real economic activity while prices were still rising. The Board staff's

GNP projections called for a contraction in real activity in early 1970, accompanied by rising unemployment. If those projections were realized, the Committee might shift abruptly from a position of extreme restraint to one of extreme ease while price pressures were still unchecked, thus adding additional strength to inflationary expectations. The appropriate strategy for monetary policy in the current situation was to set the stage for long-run noninflationary growth by shifting now to a position of moderate restraint--one that could be maintained until inflation was brought under control. That type of adjustment in current policy would involve a change from recent high negative growth rates in the bank credit proxy to sustainable positive growth rates in the range of 2 to 6 per cent. The staff's September projection for the bank credit proxy--calling for growth at an annual rate of 2 to 5 per cent--was encouraging, since it was consistent with noninflationary growth.

Mr. Hickman remarked that policy alternatives were limited for most of the period until the Committee's next meeting by even-keel considerations. He would support either of the staff's alternatives for the directive as modified by Mr. Axilrod, provided that the Manager was instructed to permit an increase in the bank credit proxy in September of about 5 per cent. Since the term "monetary aggregates" as used in alternative B included bank credit as well as deposits, it might be clearer to some readers if the reference was to both monetary and credit aggregates.

In concluding, Mr. Hickman said he would favor leaving the discount rate and Regulation Q ceilings unchanged.

Mr. Sherrill said more and more signs were appearing that the Committee's policy of restraint was becoming effective. He was most encouraged by the trend in corporate profits--because he thought a profit squeeze would have to occur before there was a reversal of inflationary pressures--and by the trend in employment.

However, Mr. Sherrill continued, those signs were still of a preliminary nature. Accordingly, he thought the Committee could not afford to relax monetary restraint to any significant extent at present. He was disturbed by the degree of restraint implied by the recent movements of the monetary aggregates. But he was not particularly confident of the accuracy of the figures in the current setting, just as he was not confident that the data on bank credit accurately reflected actual developments in that area.

All things considered, Mr. Sherrill observed, he favored a policy of even keel and adoption of alternative A for the directive. While he recognized that the Committee had to accept the risks involved in the current degree of restraint he did not think it would be desirable for any additional restraint to develop during the coming even keel period. In his judgment the Manager should pay close attention to the possible need for implementing the proviso clause.

Mr. Brimmer observed that Mr. Solomon had focused on the longer-run outlook for the balance of payments in his presentation today. He (Mr. Brimmer) thought the Committee should not lose sight of the unfavorable short-run outlook. As indicated in the green book, a considerable part of the rise in the liquidity deficit in the second quarter resulted from transitory factors, including outflows of U.S. dollars to the Euro-dollar market. However, there also appeared to have been some deterioration in the basic position. One major factor in that connection was a large increase in direct investment outflows to Western Europe.

Mr. Brimmer noted that from time to time he had reported to the Committee on developments in connection with the voluntary foreign credit restraint program. He had to report today that a new campaign seemed to be under way to dismantle more and more of the program--not only the direct investment program but also the programs for financial institutions administered by the Federal Reserve. People in the Administration as well as at banks were raising the question of exempting export financing from VFCR ceilings, partly on the grounds that recent unfavorable developments in the trade account could be traced to the VFCR program. He had been resisting such arguments, but he thought they would continue to be heard.

As to monetary policy, Mr. Brimmer remarked that the Committee had reached the point at which it was plagued by doubts as to whether it was overstaying its policy of restraint. Such doubts were natural; their absence would have reflected an insensitivity to the mixed nature of recent developments. However, he favored no change in policy at this time, both on economic grounds and in light of the Treasury financing. Although it had been suggested that monetary policy might inadvertently have become more restrictive than the Committee had intended, he would note that he considered the present stance of policy appropriate.

Mr. Brimmer said he gathered that the directive language proposed by Mr. Axilrod, designed to take some of the edge off the current degree of market tightness, really constituted what might be called "alternative C". He personally favored alternative A over both Mr. Axilrod's proposal and the alternative B language embodying Mr. Mitchell's suggestion for the proviso clause. As to the latter, he thought use of the term "monetary aggregates" in the proviso clause would be an improper step; it would put a heavy burden on the Manager for decisions the Committee itself should be making. He hoped the Committee would not adopt alternative B simply in reaction to outside criticism, particularly since the nature of such criticism was mixed. He agreed that the concept of bank credit needed rehabilitation. However, both the Committee and the Manager were aware of the problems, and there would seem to be little advantage to shifting to a collection of imperfect aggregates. In any case, the problems with the concept of bank credit would be reduced if the Board were to take regulatory action to close some of the existing escape hatches, such as sales of commercial paper by bank holding companies.

At the same time, Mr. Brimmer continued, he would not want to delay consideration of Mr. Mitchell's recommendation until Mr. Maisel's committee on the directive had had time to report. He understood that that was Mr. Maisel's view also.

In a concluding comment Mr. Brimmer said he would like to caution the Committee members and staff that at this particular juncture questions of statistics were not neutral, given recent regulatory actions and the continuing public debate over monetary policy targets. It was necessary for the System to exercise care in the way it reported and commented on the statistical series it produced. He had been hopeful that the seasonal and other revisions being made in the money supply series would have been completed by this time. However, he understood that, as a result of difficulties that had been encountered with benchmark figures for nonmember banks, publication of the new data would be delayed until about the end of the month. It would be unfortunate if public statements were made about the probable results of the revision work while that work was still in process. He was not proposing any kind of censorship, but rather suggesting that it be recognized that the official statistics on such variables as the money supply were those published by the Board.

Mr. Maisel remarked that it was most interesting to reread the memorandum of discussion prepared for the previous Committee meeting. There had been an extremely useful debate over the concept of greater or less ease or restraint. However, what came out clearly from the memorandum for that meeting--and would be reflected in that for today's meeting also--was the fact that members of the Committee were not always talking about the same subject. In about one-half of the cases, members were talking about the ease or restraint in short-term money market conditions, i.e., the day-to-day target given to the Manager. In the other half they were discussing ease or restraint in regard to over-all monetary policy, i.e., changes in the monetary aggregates and rates, or the creation and borrowing of credit by potential spenders. The tone of individual remarks varied more as a result of which target members had in mind than as a result of differences in basic views as to the Committee's ultimate goals.

It seemed clear to Mr. Maisel that very few members of the Committee wanted a further increase in the difficulty of obtaining funds or in the interest rates charged for them. On the other hand, a majority did fear the market's reaction to any change in money market conditions. It was the dichotomy between those two different views of targets that was important now and for the next several meetings. A look at the difference in the trends in money market conditions compared to the movements in the more general measures of monetary policy made the problem of bridging the gap clear.

One could argue that since June money market conditions had not changed significantly, Mr. Maisel continued. Free reserves, the short-term Treasury bill rate, the Federal funds rate, and dealer borrowing costs all reached levels close to recent ones at some point in June. Others might disagree that there had been no further firming because Federal funds, dealer borrowing rates, and Treasury bill rates had all been above their June average level for the past month. Personally, he would characterize the situation as a continuous firming in money market conditions until just prior to the last Committee meeting, at which time tight money market conditions reached a peak. As a result of that meeting there had been no further tightening and perhaps a slight easing.

In contrast to that picture of money market conditions, Mr. Maisel said, measures of monetary policy based on money, credit, and interest rates reflected a rising level of firmness or constraint, with restraint expected to continue to grow given the current levels of money market conditions and residual liquidity. Measures based on the levels of liquidity, the amount of reserves furnished, and the actual flows of monetary and credit aggregates had shown steadily increasing firmness and restraint ever since the start of the year. The pressures on spending from those sources had accelerated over the past three months. Those facts to many were a clear indication that the pressures exerted by the Federal Reserve had continued to build. Previous liquidity as a source of credit had been used up. Commitments had been drawn upon. Cash had been spent. At the same time, the total level of available bank credit had actually decreased. While one could juggle figures to measure the extent of such decreases, he thought there could be little doubt that for this third quarter of the year almost all monetary and credit variables--and particularly those most strongly influenced by the Federal Reserve--would show record low levels of growth or maximum levels of contraction for all of recent history. In fact, at no time in the past 20 years had all of those measures exerted as much pressure on the economy.

Mr. Maisel remarked that the fact that monetary impacts continued to grow more restrictive even with no increased firmness in money market conditions was, of course, a familiar phenomenon. The Committee members all recognized that money market conditions primarily measured marginal forces. Lending activity, however, depended only partly on marginal rates and reserves. It resulted even more from uses of prior sources of liquidity and from the level of marginal rates relative to economic demands. Those relative rates also influenced the rates at which the System furnished or destroyed reserves--an important component of total liquidity, spending, and monetary policy. Those relative forces had worked to increase restraint even without further firmness in money market conditions. They were continuing to increase restraint--perhaps at an accelerating pace.

It was the dichotomy between those very different trends in the two types of targets that made it so important that the Committee focus its discussion on methods of bridging the gap between those two views of what the Committee did, Mr. Maisel observed. The Committee did instruct the Manager in terms of money market conditions. It did so, however, to set a particular monetary policy in order to influence final spending, output, employment, and prices. It should be as certain as it could that the money market conditions it set would lead to the monetary policy it desired.

He fully recognized, Mr. Maisel continued, that some members of the Committee believed that any change in money market conditions was dangerous because it might have a psychological impact on spending. It seemed even clearer that such dangers had to be weighed against the fact that holding money market conditions constant probably would lead to a continued acceleration of restraint in monetary policy, sharper impacts on rates, and greater pressure against those types of spending primarily influenced by monetary restraint.

If money market conditions did ease, Mr. Maisel said, the System could make it clear that they were not a real measure of monetary policy. It could do even more to insure that when it changed money market conditions to get the monetary policy it desired, it minimized the undesirable consequences of the change. The concept of the proviso was to make certain that changes in money market conditions did not lead to unwanted changes in monetary policy. For numerous reasons, recently it had not been used for that purpose. Perhaps if the Committee adopted Mr. Mitchell's suggestion for rewording the proviso the members could all accept it more readily as an insurance against an unwanted change in monetary policy. He would support alternative B which would give others the necessary guarantee against a spurt in the monetary aggregates, but he would not want the Desk to allow a further tightening in the immediate period under any wording of the directive. More importantly, if the Committee failed to set its targets in terms of monetary policy, it could not insure against undesirable effects. Instead, it might be increasing the odds that it would find it harder and harder to change money market conditions in a reasonable and timely manner.

With respect to Desk action in the coming period, Mr. Maisel felt the current week--before the Treasury financing--would be a very good one to accept some lower values for the day-to-day money market indicators. The Treasury special certificates were furnishing reserves on a temporary basis. The System would be wise not to scramble unduly to try to get the net borrowed reserve figure up to $1 billion or to try as hard as in the past to force the Federal funds rates up on the last day or two of the week. The Desk had been very active with reverse repurchase agreements. It seemed to him the Committee would be better off if a more relaxed attitude toward day-to-day money market conditions was maintained for the next month. The altered proviso clause should serve to insure that the Committee followed the basic monetary policy it desired even as money market conditions were less firm.

Mr. Mitchell remarked that he was in basic agreement with much of Mr. Maisel's analysis, and would add just a few comments. The Committee had been saying right along that it wanted to maintain a policy of firm restraint, while members of the staff had been reporting that policy was getting tighter and tighter. On the basis of any reasonable interpretation of the facts it was clear that the restraint in train was substantial and that it was getting tighter and biting deeper almost week by week. When the System had begun to move toward firmness last December, it had been recognized that a considerable period of time would elapse before the effects on prices became apparent. It was important that the members not act now as if such lags did not exist.

It was becoming increasingly likely, Mr. Mitchell continued, that a major recession would result unless the Committee made some change in its policy. He did not know whether a major recession was needed, but he concurred in Mr. Axilrod's suggestion that it would be desirable to take the edge off restraint at this time. He favored the directive language Mr. Axilrod had proposed.

Mr. Mitchell observed that there were two possible ways of reversing the current declines in the aggregates. One was to supply enough reserves to make demand deposits grow. The other was to raise the Regulation Q ceilings sufficiently to permit the process of intermediation to resume at banks. Some members of the staff thought there would be a resumption of intermediation in September, but that was conjectural. In any case, this was the third meeting in succession at which staff members had recommended some slackening off in the degree of restraint, and he thought the Committee should adopt Mr. Axilrod's prescription today.

Mr. Heflin remarked that the Fifth District economy continued to show mixed signs, but respondents to the Richmond Bank's survey reported growing evidence that business activity was slowing. However, as yet there were no firm statistics to confirm that development. He had been expecting that many more signs of moderation would be available by now both in the District and in the nation. The continuing scarcity of such signs in the face of the Committee's very tight policy provided convincing evidence that inflationary psychology was indeed still deeply entrenched.

While the issue of policy seemed to Mr. Heflin to be delicately balanced at the moment, he favored maintaining the present degree of restraint. It was true, of course, that signs of moderation were somewhat more numerous than they had been, but they were not yet convincing. The weakness in leading indicators, for example, was confined largely to those in the housing sector--a sector hard hit by tight money. Similarly, the demand for plant and equipment expenditures would probably show a great deal more strength were it not for the difficulty in obtaining financing. Finally, he suspected that the consumer could well loosen his purse strings if credit were more readily available. In short, he had the distinct feeling that the desire to spend was still quite strong. If that was the case, any easing of policy would be likely to loosen the floodgate as people concluded that the Federal Reserve had again changed its policy position. In addition, a shift towards an easier policy would violate even keel and would probably lead to speculation in the coming refunding. While he strongly sympathized with the idea embodied in alternative B, he preferred to retain the usual proviso clause--at least this time--in view of even keel considerations. Accordingly, his choice was alternative A.

Mr. Clay expressed the view that monetary policy should be left essentially unchanged for the present. Once again, some evidence could be advanced pointing toward moderation in the pace of economic activity, and such evidence was encouraging. Moreover, recognition had to be given to the lagged impact of monetary policy on the economy.

The crucial factor to be weighed in the present policy decision, Mr. Clay continued, was the magnitude of current spending and the price inflation problem. Both domestic and international considerations underscored the importance of bringing the inflation under control. Evidences of continuing strength in the economy did not warrant a compromise with the objective of price stability. On balance, the economy was strong and costs and prices were still advancing at a disconcerting pace. The labor market, which had been so strategic throughout this inflationary episode, remained very tight, and wage pressures continued extremely strong.

There was, of course, a risk of overdoing and overstaying, Mr. Clay noted. But there also was a risk of relaxing too soon and setting the stage for an intensification of the inflationary spiral. In the present economic situation, with the inflationary background of recent years, the latter still appeared to be the greater risk. At the same time, progress had been made in the effort to reduce imbalances in the economy, and the System would need to be alert to recognize the need for a different emphasis in policy. The forthcoming Treasury financing operation also would be a factor to take into account in the interval until the next meeting of the Committee. Presumably, avoidance of any overt change in policy would be preferable during the period for that reason too.

The staff draft of the policy directive appeared to be generally satisfactory, Mr. Clay said. Selection of a proviso clause was more difficult. Under present circumstances, the bank credit proxy was quite unsatisfactory, but there was a question as to whether the proposed substitution was workable--that is, whether and how a group of monetary aggregates could be employed successfully for modifying the primary instruction to the Manager. While there was some analogy with the approach presently used in the primary instruction, it seemed that there would be substantial differences in the problem of implementation. All factors considered, his vote would be for alternative A today.

Mr. Scanlon commented that with national economic indicators giving off some fragmentary evidence that the pressure of demand on resources might be beginning to moderate somewhat, the Chicago Bank had again taken a close look at the evidence and opinions in the Seventh District. The result, as often was the case, was inconclusive.

Residential construction, especially of single family homes, continued to be the only important sector in the District in which activity had been curtailed significantly, Mr. Scanlon noted. Building permits for single family homes had fallen sharply in the District and there was every indication they would decline further. Such permits in the Chicago area in July were the lowest in the postwar period.

Activity in defense and space oriented industries also had declined, Mr. Scanlon said, but those industries were relatively unimportant in the District. Price reductions for building materials and agricultural products in recent weeks had been more than offset by price increases for a wide variety of other goods and services. Higher expenditures of State and local governments had necessitated sharp increases in property and excise taxes and, in Illinois, the imposition for the first time of an income tax. Large recent and prospective increases in salaries of State and local government employees suggested still higher taxes would be needed. Higher State and local taxes were regarded by many workers as another reason for demanding larger increases in compensation, so he was not too optimistic about the prospects for more moderate wage settlements in the near term. The demand for labor continued very strong.

Orders for most types of business equipment had continued to increase, although a sharp decline was reported for machine tools in July, Mr. Scanlon observed. Demand for farm equipment, the weakest equipment sector, appeared to have improved somewhat in the summer. Steel output remained at the reduced July level in August but a vigorous seasonal upswing was expected in the fall. Production had been handicapped by labor shortages and inadequate maintenance of equipment. The companies with whom Reserve Bank personnel had talked had raised their estimates of 1969 production and now expected it to be a record. Detroit sources had shown concern about the reduced rate of passenger car sales in July and August but currently projected fiscal year 1970 sales, including imports, at the same level as the record sales in the twelve months that ended June 30. Demand for trucks, especially heavy models, remained very strong. The unit sales of passenger cars might be depressed somewhat by the large numbers of small trucks sold for general household and recreation uses. Output of autos and trucks in September--and in the third quarter as a whole--was expected to be larger than a year earlier. Observations in the Seventh District, therefore, provided only very limited support for the view that demand pressures were easing or were quite certain to ease significantly in the near term.

Reports from District banks continued to suggest some easing in the heretofore very strong demand for bank credit, Mr. Scanlon observed. For July and August together, business loan growth had been significantly smaller than in most other recent years, even when adjusted for loans sold. While some of the slower growth undoubtedly reflected restrictive loan policies, loan officers of 40 per cent of the Chicago Bank's reporting panel indicated in the August lending practices survey that they either were already seeing a moderately weaker demand or expected to see it in the three months ahead. Among those were people from four out of the five largest Chicago banks.

Major Chicago banks had again become heavy buyers of Federal funds, Mr. Scanlon continued. With the new reserve requirements on funds acquired from abroad, Federal funds would now be a relatively attractive source for needs above the reserve-free base. Liquidation of Governments and other securities had continued at both reserve city and country banks and borrowings at the window continued at the high level of the past few months, with a relatively small proportion accounted for by the money market banks.

Mr. Scanlon observed that the monetary and credit aggregates continued to be difficult to interpret, in part because of distortions introduced by Regulation Q. Bank credit reflected the continued run-down of CD's. Total reserves reflected both the run-off of CD's and the increase in Euro-dollars. The recent revision in money supply also reflected the substitution of certain Euro-dollars for CD's. Nevertheless, he continued to feel that close attention to the aggregate series would provide the best clues to appropriate policy objectives and to the impact of policy. The money supply, defined as currency and demand deposits, probably had been affected less than the other aggregates by the disintermediation and, therefore, might provide the best clues for policy at this time. However, he would not object to Mr. Mitchell's proposal that the Manager be directed to be responsive to shifts in other aggregates as well.

In light of the economic developments reviewed today and the pending Treasury financing, Mr. Scanlon said, he favored continuation of a policy aimed at achieving about the same conditions in money and short-term credit markets as had prevailed on average since the last meeting. If the staff projections were correct, he thought the Manager was going to have some serious problems to resolve between now and the next meeting. While he (Mr. Scanlon) would guard vigorously against any further tightening, he would be opposed to fine tuning to the extent some had suggested. He favored giving the Manager sufficient latitude to permit him to try to maintain even keel conditions.

Mr. Scanlon added that he found it rather difficult to choose between the proviso clauses in alternatives A and B of the draft directives. Since he could not defend the shortcomings of bank credit at this time, however, his choice would be alternative B.

Mr. Galusha remarked that while he felt a little uneasy, he was nevertheless this morning for no change in Committee policy. He could live with either alternative of the draft directives and with the money and short-term credit market targets given in the blue book.[1/] Leaving policy unchanged, at least for a while yet, was apparently consistent with the new GNP account projections

1/ The blue book passage referred to read as follows: "An unchanged constellation of money market conditions may be considered to include a Federal funds rate averaging around 9 per cent, member bank borrowings in a $1 billion - $1-1/2 billion range, and net borrowed reserves around $1 billion. Under these conditions, the 3-month bill rate may fluctuate in a 6-3/4 - 7-1/4 per cent range, about the same range as in recent experience."

provided in the latest green book. The average unemployment rate for the second quarter of 1970 was still reckoned at 4.5 per cent, however, and unhappily, all things considered, that seemed a not unreasonable target value.

Mr. Galusha noted that the Board staff had revised downward its housing starts estimates for the third quarter of 1969 and the several quarters following. That revision, he thought, was entirely reasonable. The staff had also revised upward its estimates of business fixed investment spending for the first and second quarters of 1970. The current figure, an annual rate of $101 billion, was $4 billion higher than that which appeared in the August green book. The staff was no doubt persuaded--and rightly, he was sure--by the most recent plant and equipment spending survey findings. As a first approximation, the Committee had to accept those findings. But it should perhaps be a little skeptical. It would seem too easy for survey respondents simply to assume, as some might have, that whatever happened there would be a spending catch-up in 1970. As the Board staff recognized, actual quarterly increases in real output could well be smaller than those presently expected; and the unemployment rate could increase more than was anticipated.

Mr. Galusha said he had read Mr. Mitchell's memorandum with considerable interest and felt that it deserved the Committee's immediate consideration. With Regulation Q rate ceilings effective, adjusting the bank credit proxy--or, if he might be more direct, finding out what had been going on--had been a struggle. When the details of that struggle got out, the Committee might even appear a little ridiculous to those who played the numbers game retrospectively. Certainly, the credit proxy, however adjusted, was not as revealing or indicative as it once was. He was, therefore, inclined to accept Mr. Mitchell's proposal that "monetary aggregates" be substituted for "bank credit" in the proviso clause of the directive. He would prefer using a single aggregate if that were possible, but Mr. Mitchell's view that the Committee was not likely to agree on which aggregate to use was probably providential.

Mr. Galusha said he shared some of Mr. Hayes' reservations about placing too great reliance upon a new constellation of numbers. Certainly, the Committee did need to re-examine continually the frameworks within which it made its judgments, but because those frameworks so quickly became cast in concrete, he urged caution. Five areas of confused statistical dialectics were not necessarily an improvement over one.

So, while favoring the spirit of Mr. Mitchell's proposal, Mr. Galusha hoped that Mr. Maisel and his committee on the directive would one day soon give the Open Market Committee a well-reasoned justification for some single best monetary aggregate, possibly the narrowly defined money supply. He would even accept a strictly empirical justification. Which of the monetary aggregates was the best leading indicator, or predictor, of nominal GNP? That aggregate was the one the Committee should use, he thought, unless he badly misunderstood the purpose of the proviso clause. In any event, it had never been clear to him why in the beginning the Committee had decided upon bank credit as the monetary aggregate to be included in the proviso clause.

Mr. Galusha observed that much had been said today--and in the last ten or eleven meetings--about public psychology. Of all the fickle, unpredictable aggregates to measure that was the worst. In pursuing its central obligation to foster the appropriate economic environment, the Committee should not forget that monetary lags worked both ways, even though he believed the lag coming out of this period of monetary restraint would be much shorter than that going in. The Committee's relaxation of restraint should be very gradual if the Committee was to avoid a lurching policy; no matter what differential there might be in timing, policy had to be prospectively inspired. Therefore, the Committee would be leaning against the wind of public opinion if it did its job.

Mr. Galusha did not think today was the day for a change. This September was fraught with enough monetary uncertainties without having the Committee injecting any more. But time would begin to run against the Committee as the fall wore on.

Mr. Swan said that no over-all employment figures for the Twelfth District were available for August, but employment in the aerospace industry, which was highly important in the District, had continued to decline in July and further reductions were quite likely in subsequent months. There were some indications that the July outflow of funds from California savings and loan associations had continued in August. The five associations in the San Francisco Reserve Bank sample reported a combined loss about equal to the gains they had experienced in August 1968; of the five institutions, four reported losses and one reported a small gain. He doubted that there would be any improvement in the final month of the quarter, given the level of competitive market interest rates and the widespread policy among the California associations of paying interest on a daily basis, thereby removing the incentive for investors to maintain their deposits until the interest-crediting period.

Mr. Swan noted that tomorrow the State of Alaska would be opening bids for oil leases on the North Slope and, more importantly, the amounts involved would be made known. Downpayments equaling 20 per cent of the bids had already been deposited with the State and the 80 per cent balances due on the winning bids were to be paid shortly.

With respect to Committee policy, Mr. Swan indicated that he was in favor of a no change directive at this meeting, in light of the current economic situation and the approaching Treasury refunding. Like other members, however, he was concerned about the increasing impact of the policy the Committee had been maintaining. In his opinion the Manager should exert every effort to avoid any further tightening in the weeks ahead, whether in terms of money market conditions or in terms of the broader measures of monetary influence. In other words, the seasonal and special factors that lay ahead should not be allowed to create a tighter over-all credit situation than prevailed at the moment, difficult as that might be to accomplish. He thought the Manager had to be given latitude to achieve that objective.

In that regard, Mr. Swan continued, the choice of the proviso clause became pertinent. He found himself in full agreement with Mr. Mitchell's view that the Committee should not continue to limit the proviso clause to bank credit. Committee members were fully aware of the shortcomings of measures of bank credit and outside observers were becoming increasingly cognizant of the limitations of the proxy series for bank credit. Yet, the directive itself offered no indication of the Committee's reservations. To be sure, the Manager had to take account of bank credit developments in his operations, but he also had to view such developments in the light of other considerations.

Mr. Swan added that he was not persuaded the Committee would one day find the magic monetary aggregate to guide its operations. Accordingly, he thought the use of several monetary aggregates might be preferable to one, with the emphasis on particular aggregates varying as circumstances changed. The Committee should give the Manager as much guidance as it could with respect to the weight to be given to each of the aggregates, although it could not remove all of the burden from his shoulders.

Mr. Swan said he appreciated the semantic problem mentioned by Mr. Hayes, concerning the possible interpretation of alternative B as reflecting the adoption of a monetarist position by the Committee. His (Mr. Swan's) solution would be to broaden the language of the proviso clause by referring to "bank credit, bank reserves, and monetary aggregates." He thought such language would be consistent with Mr. Mitchell's objective and would also help clarify the Committee's intention to avoid any further tightening in terms of the aggregates.

Mr. Coldwell said that conditions in the Eleventh District could be generally characterized as a high level holding position without significant movement. Banking conditions reflected a tone of slightly less restraint as borrowings had declined at the Reserve Bank, a seasonal deposit increase had developed partly from ASCS[1/] payments to farmers, and a minor slippage had occurred in loan demand.

At the national level, Mr. Coldwell continued, the economy gave the appearance of less strength but not of a definite downturn.

1/ Agricultural Stabilization and Conservation Service.

Production and employment measures were not as strong as earlier, but only housing construction seemed to show a deteriorating condition. Wage and price movements were still causes for deep concern, and there was a renewed pessimism that such trends would continue through 1970 with only slightly less pressure. Thus, the restraint on credit appeared to be the primary force holding back a further acceleration of capital and consumer spending. The new curtailment of Federal construction would be helpful but, over all, the restraint from fiscal policy might be weakening and, perhaps of equal importance, businessmen and consumers thought that that restraint was weakening. Perhaps progress was being made but it was painfully slow.

Mr. Coldwell indicated that in formulating his policy position he had reviewed the conditions, tone, and statistical evidence relating to the money and capital markets over the past three months. If one judged only by such statistical measures as the bank credit proxy, non-borrowed and total reserves, Treasury bill rates, Federal funds rates, or net borrowed reserves, the conclusion could be that restraint had been fairly even or perhaps that some intensification had occurred. If, on the other hand, one injected the tone of the market, the reports from bankers, and the feeling that loan demands were being accommodated despite limitations on the supply of lendable funds, a conclusion of perhaps less restraint emerged. It was his position that the

Committee had not maintained the tone of restraint evident at the time of its June and July meetings even though the Committee's directives had been aimed at that objective.

Obviously, Mr. Coldwell said, the forthcoming Treasury refunding had to dominate the Committee's policy in the coming weeks. However, he believed the Committee should aim at holding the degree of restraint measured by the tone and feel of the market and banking conditions that was evident six to eight weeks ago. Given the supplies of non-deposit funds to banks, the sales of loans and securities off bank balance sheets, and the seasonal factors, he believed the Committee should be looking at a set of statistical indicators showing net borrowed reserves of $1.0 billion to $1.2 billion and member bank borrowings above $1.2 billion. He did not think it wise to specify a range for bill rates since varying pressures might move those rates widely. However, he thought the Federal funds rate should average about 9-1/2 per cent.

Mr. Coldwell said he would favor alternative A of the draft directives, but he would drop the proviso clause which had embroiled the Committee in a semantic tangle. Under current circumstances the reference to bank credit in the proviso embraced three separate definitions of the credit proxy and left to the Manager the problem of deciding how to resolve conflicting movements among them. Since he had little faith in the credit proxy data and since he believed that the Manager would accommodate and adjust to massive international flows or to a special tightening from the new Board regulations, he would prefer no proviso.

As to Mr. Mitchell's suggestion, Mr. Coldwell continued, he thought use of "monetary aggregates" in the proviso would result in problems similar to those connected with bank credit. If his own count was correct, six different aggregates would be involved in a proviso of the type Mr. Mitchell proposed. On the other hand, he (Mr. Coldwell) applauded the suggestion as representing a further contribution to the continuing analysis of the directive. He would hope that Mr. Mitchell's suggestion and others would be carefully studied by both staff and Mr. Maisel's committee. Perhaps with a full range of alternatives the Open Market Committee could devote a special meeting to the form and structure of the directive and the statistical measurement of policy.

Mr. Morris said he found himself in general agreement with the analyses set forth by Messrs. Gramley and Axilrod. The response of the economy to a tight monetary policy had been painfully slow, but he thought it was very clear that the Committee was making headway and needed to exercise a little patience. He would accept the staff projections as an appropriate policy guide with the proviso that he thought the Committee's restrictive policy had already built into the system a more severe decline in housing starts than the staff had projected.

While the Committee awaited the results of its past actions, Mr. Morris continued, its major problem, as he saw it, was to formulate a policy which would prevent financial pressures from becoming cumulatively more severe. It was too early for any overt, dramatic change in policy, but he thought the Manager should be instructed to lean against the momentum of increasing restraint which the market had generated in recent months, and which he thought the market would continue to generate unless the Manager took offsetting steps.

Mr. Morris said he believed monetary restraint was now much more broadly diffused than it had been a few months ago. During the spring months, the pressures had been centered primarily on the large banks which were well equipped to bear them. In recent months, however, the pressures had spread to the smaller banks and to the nonbank intermediaries, most of which were much less well prepared to deal with severe liquidity pressures. If the Committee stayed on its recent policy course, he thought it ran the risk of producing severe financial disruptions even before it had seen much in the way of policy results in the real economy.

For those reason, Mr. Morris said, he would favor Mr. Axilrod's proposed language for the directive and would give the Manager more scope for allowing fluctuations in short-term money rates. The very modest shift in policy emphasis implied in the Axilrod alternative was not, in his judgment, incompatible with even keel considerations.

Parenthetically, Mr. Morris noted that the language Mr. Axilrod had proposed in the meeting today had not been included among the alternatives the staff had submitted in advance. He would have found it helpful to have had that language along with the other alternatives, and he suggested that before each meeting the staff distribute all alternatives it planned to offer for Committee consideration.

Mr. Morris thought that Mr. Mitchell's proposal for the proviso clause was a sound one. The Committee had, in effect, abandoned the bank credit proxy, and judging from the Manager's statements he had also abandoned it as a guide to operations. He (Mr. Morris) agreed with Messrs. Mitchell and Swan that the Committee's public posture would not be enhanced if it continued to publish a directive which implied incorrectly that the bank credit proxy was still a firm guide for implementing the proviso clause. He agreed with many of the comments that had been made about the inadequacies of "monetary aggregates" as a proviso clause instruction, but in the absence of any superior suggestions such an instruction would be a more accurate reflection of the Committee's present thinking. Perhaps a broadening of alternative B--possibly by use of the words "monetary and credit aggregates", as suggested by Mr. Hickman--would make it easier for the Committee to adopt such a proviso. In any event, he (Mr. Morris) was not overly concerned about the risk that outsiders might conclude that the Committee had moved to a monetarist view of monetary policy.

Chairman Martin remarked that the task of reaching a decision today appeared to be a relatively simple one. It seemed clear that a major change in policy would not be appropriate at this juncture because of the Treasury financing. The only real matter for debate was whether the Committee should try to engage in fine tuning, and he personally had become increasingly skeptical about the efficacy of such efforts.

Fluctuations in the Treasury's cash balance would continue to complicate open market operations for a time, the Chairman observed. In his judgment the Manager had done an excellent job in recent weeks in coping with the money market problems resulting from such fluctuations; although it had not been possible to foresee the intensity of the problems, the Desk had managed to maintain a reasonable amount of stability in money market conditions.

Both Mr. Mitchell's memorandum on the directive and Mr. Maisel's comments today pointed up some of the problems facing the Committee, the Chairman continued. He would not favor changing the form of the proviso clause at this time, although he had some sympathy for Mr. Mitchell's suggestion and thought the Committee should continue to study it. As he had noted on other recent occasions, there was a danger of succumbing to "statisticalitis." He agreed with Mr. Brimmer that statistics were no longer neutral.

To a large extent, the Chairman observed, the risks it was necessary to run in conducting monetary policy at this juncture derived from the long period of mishandled fiscal policy, although past monetary policy was not blameless. Much of the current problem was one of psychology and, as had often been noted, it was extremely difficult to deal with problems of psychology. While he had some sympathy with Mr. Axilrod's comment that the constraint of even keel might have been overemphasized in the past, a relaxation of that constraint now was likely to be misinterpreted and to compound the psychological problem.

Chairman Martin expressed the view that the Manager would have to bear the burden of whatever modest adjustments might be needed in the coming policy period, and that he should be given a high degree of latitude for that purpose. It was at the next meeting, rather than today, that the Committee itself would make a critical judgment. The next meeting obviously would be an important one, and he hoped that in the interim the members would be carefully assessing all of the factors bearing on the decision it would be necessary to make then.

As to the directive, the Chairman said, he personally favored alternative A of the drafts. Although the members were not unanimous, it appeared from the go-around that a majority favored that alternative. He proposed that the Committee vote on alternative A in the form submitted by the staff.

> With Messrs. Maisel and Mitchell dissenting, the Federal Reserve Bank of New York was authorized and directed, until

otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting indicates that expansion in real economic activity slowed somewhat in the first half of 1969 and some further moderation during the second half is projected. Substantial upward pressures on prices and costs are persisting. Long-term interest rates recently have risen to new peaks, while short-term rates have changed little on balance. In August the money supply decreased while U.S. Government deposits rose somewhat; bank credit declined further on average; the run-off of large-denomination CD's continued without abatement; and there were further net outflows from consumer-type time and savings accounts at banks. The U.S. foreign trade surplus was very small in July. The over-all balance of payments deficit on the liquidity basis remained very large in both July and August, while the balance on the official settlements basis shifted into deficit in August as U.S. banks' borrowings of Euro-dollars leveled off. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

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

Mr. Maisel said he wanted to make it clear that his vote was against a directive which in his view called for a continued tightening of monetary policy by placing its target purely in terms of money market conditions even as those, interacting with reserve creations, changes in liquidity, and the demands of the economy, created the tightest monetary policy in the past 20 years whether measured by changes in the monetary aggregates, bank credit, or interest rates.

Chairman Martin then noted that the Committee had planned to continue its discussion today of possible outright System transactions in Federal agency issues. However, a decision did not appear to be urgent and Mr. Robertson, who was not present today, held strong views on the subject. Accordingly, he proposed that the matter be held over until another meeting of the Committee. As the members knew, he would be presenting System testimony at Congressional hearings tomorrow on extension of the underlying legislation.

There were no objections to the Chairman's proposal.

Chairman Martin then noted that memoranda had recently been distributed to the Committee from the Manager, Committee Counsel, and the Secretariat, relating to the subject of System lending of Government securities.[1/] He asked Mr. Holmes to comment.

1/ Of the memoranda referred to, two had been distributed on August 26, 1969. These were from Mr. Holmes, dated August 22 and entitled "System Lending of Securities," and from Mr. Hackley, dated August 25 and entitled "Legality of plan for System lending of Government securities." The Secretariat's memorandum, dated September 8, 1969, was entitled "Suggestion for modification of proposed amendment to continuing authority directive." Copies of these memoranda, and of the two attachments to that from Mr. Holmes have been placed in the Committee's files.

Mr. Holmes remarked that, as the Chairman had noted, the Committee had before it his memorandum of August 22, Mr. Hackley's memorandum of August 25, and the Secretariat's memorandum of September 8. As the last document indicated, he concurred with the modifications suggested by Mr. Hackley and by the Secretariat in the amendment he had proposed to the continuing authority directive.

As far as the substance of the matter was concerned, Mr. Holmes continued, the Committee would recall that the joint Federal Reserve-Treasury Steering Committee on the Study of the Government Securities Market had concluded that the lending of securities by the Federal Reserve System to minimize the volume of fails in the Government securities market and to facilitate Reserve Bank security clearing arrangements would contribute significantly to an improvement in the functioning of the market. A preliminary discussion of the proposal had been undertaken at Open Market Committee meetings in August and September 1968. Some Committee members had indicated support for the proposal, while others had expressed reservations on legal or other grounds. The proposal was never put to a vote, however, in view of Counsel's opinion that lending of securities had not been demonstrated to be necessary to accomplish the objectives of open market operations.

Mr. Holmes observed that over the past year, as his memorandum of August 22 pointed out, the fail situation in the

Government securities market had deteriorated to the point where the lack of lending facilities in the market threatened to impair the System's ability to achieve desired money market and reserve objectives effectively. The change in the factual situation was recognized by Counsel in his memorandum of August 25, 1969, and Mr. Hackley now believed that under current circumstances the practice might properly be regarded as authorized under the incidental powers of the Reserve Banks, "provided that the Open Market Committee, as well as the Manager, determines that the situation is such that the lending of Government securities is reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies."

For the reasons set forth in his August 22 memorandum to the Committee, Mr. Holmes said, he would recommend that the Committee adopt the proposed addition to the continuing authority directive contained in the Secretariat's memorandum dated September 8, 1969.

As the Committee might recall, Mr. Holmes added, the Treasury representatives on the Steering Committee--while agreeing that official lending of securities for the limited purposes presently proposed would make an important contribution towards a better market--had been reluctant to authorize lending of securities held in various Government accounts. With the legality of System lending in doubt there was little point in further exploration of the Treasury's willingness to join the Federal Reserve in lending of securities. He now understood, however, that that the Treasury, without committing itself to the outcome, would be actively considering the possibility of authorizing at least two Government investment accounts to lend securities. He believed it would be desirable to make the lending of securities a joint Federal Reserve-Treasury effort, although he was also convinced that the Federal Reserve would be on solid ground if it went it alone. In the meantime, he would be glad to answer any questions the Committee might have.

Chairman Martin noted that the legal situation with respect to System lending of Government securities evidently had now been clarified. All things considered, he thought it might be desirable to hold over this matter also, and plan on considering it at the next meeting of the Committee.

Mr. Hayes observed that he would have no objection to postponing a decision if the Chairman thought there were significant advantages to such a course. However, it had been his impression from the discussions of a year ago that in general the Committee would have been favorably disposed toward the proposal were it not for the legal reservations noted by Committee Counsel. Mr. Hackley evidently had changed his position in the light of subsequent events. Accordingly, if the advantages of a delay were not marked, the Committee might dispose of the matter today.

Mr. Brimmer commented that Mr. Holmes' memorandum had made a persuasive case for the recommendation that the System engage in lending of securities, and he (Mr. Brimmer) had been prepared to vote favorably on the matter today. However, he would not object to deferring the question if the Chairman thought that was the better course. At the same time, he understood that it would be necessary to hold discussions with market participants and others before actual lending operations were initiated. That raised the question in his mind of the time at which operations could be launched if the Committee postponed a decision until the next meeting.

Mr. Holmes remarked that the Account Management would be able to move relatively quickly once a Committee decision was taken. However, as Mr. Brimmer had indicated, it was planned to hold discussions in advance of actual operations, and those discussions might lead to some suggestions for modification in the proposed terms and conditions for lending of securities. He would be reluctant to begin that necessary ground work until he had some indication of the sentiment of the Committee on the matter.

Mr. Holland said that in Mr. Hackley's absence he might attempt to clarify one point raised in the preceding discussion. As he understood Mr. Hackley's memorandum, the latter had not changed his position since last summer; what had changed was the factual situation. It had been Mr. Hackley's position all along that such lending could properly be regarded as authorized under the incidental powers of the Reserve Banks if the Committee determined that it was reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies. Mr. Hackley, who was presently on vacation, planned to attend the next meeting of the Committee and would be able to participate in any discussion held then.

Mr. Hayes asked whether Committee members might indicate whether they had any reservations about the proposal, without committing themselves to any particular position on the matter.

Mr. Scanlon said that, although he did not necessarily object to the proposal, he did have some questions. According to the opinion of Counsel, System lending of Government securities would no longer be legally authorized "if and when it should develop that delays in deliveries of securities no longer constitute an obstacle to the conduct of open market operations." It was not clear to him (Mr. Scanlon) how the Committee would go about determining when the latter point had arrived. Secondly, he thought it was likely that the fail situation would improve only when the personnel situation at clearing banks had improved. He wondered whether System lending of securities would really help improve the fail situation, or whether it might simply amount to accommodating the personnel problems of banks.

Chairman Martin noted that in the discussions last year he originally had been favorably disposed toward the proposal but later, when legal questions came to the fore, he had thought the Committee should not move ahead until those questions were resolved. At this point he believed it would be helpful for the members to have more time to study the subject. As he understood it, there was no need for action immediately.

Mr. Holmes said it was also his view that immediate action was not essential.

Chairman Martin then asked whether there was any objection to postponing further consideration of System lending of Government securities until the next meeting of the Committee, and none was heard.

It was agreed that the next meeting of the Committee would be held on Tuesday, October 7, 1969, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

September 8, 1969

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on September 9, 1969

FIRST PARAGRAPH

The information reviewed at this meeting indicates that expansion in real economic activity slowed somewhat in the first half of 1969 and some further moderation during the second half is projected. Substantial upward pressures on prices and costs are persisting. Long-term interest rates recently have risen to new peaks, while short-term rates have changed little on balance. In August the money supply decreased while U.S. Government deposits rose somewhat; bank credit declined further on average; the run-off of large-denomination CD's continued without abatement; and there were further net outflows from consumer-type time and savings accounts at banks. The U.S. foreign trade surplus was very small in July. The over-all balance of payments deficit on the liquidity basis remained very large in both July and August, while the balance on the official settlements basis shifted into deficit in August as U.S. banks' borrowings of Euro-dollars leveled off. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

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

Alternative B

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