# 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, May 27, 1969, at 9:30 a.m.

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

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Mr. Molony, Assistant Secretary
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
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. Sherman, Consultant, Board of Governors
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
Mr. Wernick, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Messrs. Latham and MacDonald, First Vice Presidents of the Federal Reserve Banks of Boston and Cleveland, respectively
Messrs. Taylor, Jones, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Atlanta, St. Louis, and San Francisco, respectively
Messrs. Eisenmenger, Hocter, and Snellings, Vice Presidents of the Federal Reserve Banks of Boston, Cleveland, and Richmond, respectively
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis
Mr. Sandberg, Special Assistant, Securities Department, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on April 29, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on April 29, 1969, was accepted.

Chairman Martin reported that Mr. Brill, who would be leaving the staff of the Board of Governors at midyear, had resigned from his position as Economist of the Federal Open Market Committee on May 19, 1969. It had been suggested that Mr. Partee, who would be Mr. Brill's successor as Director of the Board's Division of Research and Statistics, be named as Committee Economist, and that Mr. Gramley of the Board's staff be named as Associate Economist.

By unanimous vote, J. Charles Partee was elected Economist and Lyle E. Gramley Associate Economist of the Federal Open Market Committee to serve until the first meeting of the Committee after February 28, 1970, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors, they would cease to have any official connection with the Federal Open Market Committee.

By unanimous vote, the action of Committee members on May 14, 1969, approving equalization of System swap lines with the Netherlands Bank and the National Bank of Belgium at $300 million each, and the conforming amendments to paragraph 2 of the authorization for System foreign currency operations, effective immediately, was ratified.

As a result of these actions, the table contained in paragraph 2 of the authorization for System foreign currency operations was amended, effective May 14, 1969, to read as follows:

| Foreign bank | Amount of arrangement (millions of dollars equivalent) |
|---|---|
| Austrian National Bank | 100 |
| National Bank of Belgium | 300 |
| Bank of Canada | 1,000 |
| National Bank of Denmark | 100 |
| Bank of England | 2,000 |
| Bank of France | 1,000 |
| German Federal Bank | 1,000 |
| Bank of Italy | 1,000 |
| Bank of Japan | 1,000 |
| Bank of Mexico | 130 |
| Netherlands Bank | 300 |
| Bank of Norway | 100 |
| Bank of Sweden | 250 |
| Swiss National Bank | 600 |
| Bank for International Settlements: | |
| Dollars against Swiss francs | 600 |
| Dollars against authorized European currencies other than Swiss francs | 1,000 |

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 April 29 through May 21, 1969, and a supplemental report covering the period May 22 through 26, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that the Treasury gold stock was unchanged and the holdings of the Stabilization Fund were now at a new record high of $790 million. The price of gold on the London and Zurich markets had been holding around the $43.50 level, with indications of more or less continuous South African sales.

Since the last meeting of the Committee, Mr. Coombs observed, the world had passed through another financial hurricane, in which transfers of money across the exchanges had reached new record levels. Between late April and May 9, the German Federal Bank took in roughly $4.6 billion, the Bank of England lost $640 million, the Bank of France lost $450 million, and five other European central banks lost a combined total of $550 million. Also, U.S. corporations moved heavily into marks in order to cover their mark liabilities, and such hedging operations, probably accompanied by some outright speculation, seemed mainly responsible for a record deficit of $2.4 billion in the U.S. balance of payments during the two weeks bridging the mark crisis.

Mr. Coombs remarked that the recent crisis had been more concentrated and intense than that of November 1968. In two days alone--May 8 and 9, the Thursday and Friday preceding the German Government's decision not to revalue--$2.6 billion moved into Germany. The volume of covering by U.S. corporations also far exceeded the scale reached last November, perhaps by a ratio of four to one. Another distinguishing feature was the pervasiveness of reserve losses, with particularly severe strains on some of the smaller countries--such as Denmark, which was driven close to the point of running out of money. On the other hand, the impact on both France and the United Kingdom was somewhat less severe, all things considered, than last November, largely owing to the protection secured in the meanwhile by France in the form of stringent exchange controls and by the British through a tightening of both fiscal and monetary policy.

As the Committee knew, Mr. Coombs continued, the crisis was touched off by various statements by Finance Minister Strauss of the German Government suggesting that Germany would be prepared to revalue as part of a package deal involving changes in the parities of other countries. Those statements completely disrupted the market's confidence in a political timetable--first, that Germany would not under any circumstances revalue until after the September elections, and secondly, that action on the French side was out of the question until some time in June, after the election of a new French Government. If, in fact, it had proved possible to negotiate such a package realignment of exchange rates, including an adequate revaluation of the mark, that might have represented a major breakthrough in international financial cooperation and restored the exchange markets to a reasonably firm footing. As it had turned out, the basic disequilibrium in European exchange rates not only remained, but would probably continue to deepen over coming weeks and months. The markets had treated the German reaffirmation not to revalue with cynicism and he thought it was only a matter of time before some new disturbing event would set off another massive wave of speculation. French officials expected that the French elections scheduled for this coming Sunday, May 31, might well be followed by new speculative disturbances, which could spread out into a broader movement affecting other currencies as well.

In general, Mr. Coombs said, he thought the present international situation was the most dangerous of any that had yet been encountered. As far as the United States was concerned, perhaps the primary risk was that a German refusal to revalue would sooner or later trigger a chain of devaluations elsewhere in Europe. Quite aside from sterling and the French franc, the Belgian franc and Danish krone were seriously exposed, and other currencies now in reasonably good shape might slip into an untenable position if their competitive positions were undermined by devaluations elsewhere. Such a string of European devaluations would, of course, have ominous implications for the U.S. foreign trade position, which was already bad enough.

Mr. Coombs remarked that there was a second major danger which he had mentioned to the Committee several months ago--namely, the risk that the Euro-dollar market could get into serious trouble. Earlier heavy borrowings by U.S. banks had strained the capacity of the Euro-dollar market and had forced a number of European countries into various defensive moves designed to protect their credit markets and currency reserves against the pull of abnormally high Euro-dollar rates. The resultant competitive scramble for Euro-dollar money subsequently strained the market even more, and severe new pressures had arisen out of speculation on changes in the mark and other European currencies. Finally, the June 30 window-dressing date would soon bring about seasonal withdrawals of funds from the market. That would add an additional temporary strain, even though it might be possible to take steps to recycle such funds back to the market.

Mr. Coombs said European central banks had now become so concerned over the speculative threat to their currency parities that any new threat might lead them to take drastic restrictive action on the credit side in order to protect their reserve positions. At some point, strains on both the Euro-dollar and national credit markets in Europe might produce a few spectacular bankruptcies here and there, and cast a shadow over credit risks throughout the European financial market. In that situation, it would not take much to frighten the Swiss banks, for example, into heavy repatriations of short-term funds from the Euro-dollar market.

In general, Mr. Coombs continued, the situation could be moving toward the incipient stage of a self-defeating scramble for liquidity, both official and private. He thought the main hope for preventing such a scramble lay in the swap network and other forms of central bank credit. From time to time over the next few months the System might well find certain of its swap lines quickly drawn in full--as in the case of the National Bank of Denmark, which in late April and mid-May had drawn the entire $100 million available to them. The kind of assistance marshalled for the Danes--which included a special $50 million facility extended by the U.S. Treasury and help from the Germans in the form of recycling--might very well provide the pattern for reasonable action over the next few months. Any holdbacks of needed funds on the part of central banks or other sources of funds could precipitate a sudden break in the parity structure. He thought it was of the utmost importance during this period--until some decisions could be made on the question of parities--that the line be held through full utilization of existing credit arrangements.

Mr. Coombs then remarked that he would say a few words about sterling and the French franc, in which there had been some sizable transactions since the previous meeting of the Committee. As a result of the latest crisis, the Bank of England was forced to draw another $465 million on the swap line, increasing their debt to the System to $1,415 million. In talking with both the British and German officials at the last Basle meeting, he had taken the position that such British drawings on the Federal Reserve swap line should be considered as pre-financing of a subsequent recycling of money back to the Bank of England by the German Federal Bank. As a condition for such recycling, the Federal Bank insisted on getting a credit guarantee from the German Government on such loans to the Bank of

England, and in the end only $250 million was loaned back to the Bank of England. The British would be using those funds tomorrow to pay down $250 million of their debt to the System, leaving a balance of $1,165 million. It appeared that at this moment no other central bank in the Basle group was prepared to make any further loans to the Bank of England, Mr. Hayes and he had made inquiries on that point with negative results. He (Mr. Coombs) personally continued to share the view of the market that the sterling parity was highly vulnerable and in the end probably untenable, with considerable risk that credits granted to the Bank of England might take some time to unwind.

Mr. Coombs recalled that roughly a year ago he had recommended to the Committee that its swap line with the Bank of England be put on a conditional basis, and he could think of times during the year just past when it might well have been advantageous to have put tough conditions on further British use of the line. At the present moment, however, it seemed to him that the issue of a mark revaluation, possibly in conjunction with other parity changes, had become so overriding that no useful purpose would be served in denying the Bank of England further credit until the parity realignment problem had been solved in a reasonably orderly way. If sterling became subject to new reserve losses, it might be possible to secure some further financing for the British from the German

Federal Bank under the recycling arrangements, but he did not think that could be counted on.

As for the French franc, Mr. Coombs concluded, as the Committee knew, the Bank of France had completely paid off its swap debt to the Federal Reserve through a combination of gold sales and borrowing from Germany under the Bonn credit package. Of that Bonn credit package, somewhat more than $1 billion had now been used, leaving roughly $800 million available from sources other than the Federal Reserve. A number of countries contributing to the Bonn credit package were no longer in a position to provide credit, however, and it might well be that less than $500 million really remained available. If the French ran into new difficulties, as seemed likely, he hoped that they would not hesitate to use the residual financing available under the Bonn package, plus some special recycling financing from the German Federal Bank, before turning to the Federal Reserve for new credit. But the French might well have to draw on the System again before the summer was over, possibly as early as July.

By unanimous vote, the System open market transactions in foreign currencies during the period April 29 through May 26, 1969, were approved, ratified, and confirmed.

Chairman Martin commented that, in accordance with the understanding reached at the previous meeting of the Committee, he and Mr. Robertson had discussed use of the System's swap lines by the Banks of England and France with senior officials of the Treasury. Those officials indicated that the Treasury did not have the resources that would be needed to fund the swap debts to the System that had been running on for longer terms. They had expressed the judgment that the System probably would have to proceed under the swap lines in accordance with outstanding commitments.

Mr. Coombs then noted that two swap drawings by the National Bank of Belgium would be reaching the end of their first three-month terms soon, and he recommended renewal if requested by that Bank. The drawings in question were of $2.5 million, maturing July 2, 1969, and $4 million, maturing July 3, 1969.

> Renewal for further periods of three months, if requested, of the two drawings by the National Bank of Belgium was noted without objection.

Mr. Coombs said he would also recommend renewal, if requested, of two drawings by the Bank of England--one for $50 million, which matured for the third time on June 9, and one for $100 million, which matured for the second time on June 10. As the members knew, the British swap line had been in continuous use since July 1, 1968. It was conceivable--although perhaps just barely--that the British might be able to take in enough money between now and the maturity dates to repay the two drawings in question. More hopeful was the possibility that before the end of June the British would draw $500 million from the International Monetary Fund and use roughly half of the proceeds to pay down their debt to the Federal Reserve. If so, the two drawings would be paid off shortly after they were renewed. On the other hand, it was conceivable that market developments might force the British to use the IMF drawing to meet current expenses.

In reply to Mr. Mitchell's inquiry as to the nature of British plans for dealing with their problem, Mr. Coombs observed that various possibilities had been discussed informally. In his judgment their best hope lay in a recovery of confidence in sterling. He could not say whether or not that would require a change in government. Such a recovery, by reversing the pattern of leads and lags, could bring about fairly heavy inflows to the United Kingdom, enabling them to repay most of their drawings. Beyond that, he thought their best hope lay in security placements in foreign capital markets. As the Committee knew, the British already had begun testing that device with issues in the German market of bonds of nationalized industries. Perhaps at some point the central government itself could issue securities abroad and use the proceeds to repay its existing short-term debt. Among the procedures he would consider inappropriate would be for either the System or Treasury to take on large additional amounts of guaranteed sterling or for the Treasury to repay the debt to the System by shifting the burden onto the U.S. taxpayer. While it undoubtedly would take some time for the British to move into the black he thought they would do so eventually; major industrial countries simply did not go bankrupt.

Mr. Mitchell said he was concerned about the Bank of England's debt to the Federal Reserve. Thus far under the swap network--which in his judgment had a tenuous legal foundation--the System had been quite successful in liquidating debts arising on both sides of the ledger, except in the case of the British. The duration of the British debt to the System could undermine the whole concept of the swap network.

Mr. Coombs responded that that point had been a major concern of his for the past year and had led to his suggestion a year ago that the Committee attach conditions to further drawings by the British. Alternatively, the System might have made an agreement under which the U.S. Treasury would take over debts to the System in a situation of the present sort. Other countries might get into the same situation in the future, and the System sacrificed bargaining power when it permitted unconditional use of the lines. As he had indicated earlier, however, at this juncture he did not think it would be useful to attach conditions to further British use of the line.

In reply to another question by Mr. Mitchell, Mr. Coombs said that the British had had short-term debts to others run on for considerable periods. Their longest outstanding drawing on a European central bank was nine months, but it was his recollection that some of their drawings on the BIS had run on for about 18 months.

Chairman Martin remarked that Mr. Coombs had done more than anyone else to keep the problem of British debts to the System in the forefront of the Committee's thinking. The Committee had considered his suggestion for attaching conditions to further drawings a year ago, and the matter had been discussed with the U.S. Treasury. The System did have commitments and the dangers they posed became clearer day by day.

By unanimous vote, renewal for further periods of three months, if requested, of the two drawings by the Bank of England maturing in the period June 9-10, 1969, and totaling $150 million, was authorized.

Chairman Martin then invited Mr. Daane to report on developments at the Basle meeting earlier this month.

Mr. Daane remarked that the Basle meeting in question, which he had attended along with Messrs. Hayes and Coombs, was held on May 11. On the Friday before the meeting he and Mr. Hayes had visited with President Stopper of the Swiss National Bank to discuss the German situation and related matters. It became increasingly clear in the course of the discussion that Dr. Stopper had reason to believe the Germans would not revalue the mark. The Swiss were more sympathetic than others to an unchanged mark parity, and they were relatively optimistic as to the calming effect the announcement of such a decision would have on the market. However, Dr. Stopper did mention the possibility of further market turmoil in connection with both the French and the German elections.

The Basle meeting itself was divided into two Sunday afternoon sessions, Mr. Daane continued. In the first, which was held in the conference room, Dr. Blessing relayed to those present a message from Chancellor Kiesinger reiterating the German decision not to revalue. The message also indicated that the Chancellor was disturbed about what he considered to be misinterpretations by the press of statements on the subject of revaluation by German officials. In the course of the go-around Dr. Blessing reported that Germany had experienced a speculative inflow of somewhat over $4 billion during May. The British made a strong statement with respect to their intentions not to devalue sterling--even as part of a more general realignment of parities--nor to shift to a floating rate. But, as Governor O'Brien put it, while their intentions were strong they needed help in terms of resources. In the first four months of the year the British had gained over $1 billion, but then, in nine days in May, they had lost about three-fourths of the gain.

Mr. Daane noted that there also was some discussion in the first session about the desirability of issuing a statement regarding Germany's decision not to move on the rate, with those present obviously critical of that decision. He had the benefit of having copies of the statement the U.S. Treasury had released Friday evening following the German announcement and had distributed them at the meeting. Both he and Mr. Hayes stressed the importance of adopting the same tone as the Treasury had, avoiding language that could be interpreted as critical of the German decision or that would cast doubt on the credibility of their assertion that the decision would not be altered.

Dr. Zijlstra had suggested, Mr. Daane said, that a smaller group assemble in his office to consider both what could be done in the present situation and what should be said in any statement. Mr. Hayes set the tone in that more limited session by expressing the strong hope that, in light of the concern for sterling and other points of pressure, the Germans would undertake recycling operations. In his (Mr. Daane's) judgment, Mr. Hayes performed an important service in focusing the discussion on the need for

Germany to do as much recycling as possible. The German Federal Bank officials said they were willing to recycle amounts up to about $500 million but wanted some form of backing or assurance from the German Government on any credits to Britain. As Mr. Coombs had reported, they eventually had undertaken a limited amount of recycling to the Bank of England.

Mr. Daane went on to say that after question was raised as to the advisability of issuing a communique, it was agreed that some statement was necessary under the circumstances. Following an extended discussion of language, a brief communique--which he was sure the Committee members had seen--was issued. The first paragraph indicated that the group had been advised that the decision against revaluation of the mark would not be altered and that supporting measures were being given urgent consideration by the German Government. The second paragraph reported the governors' agreement to begin recycling operations immediately, and the final paragraph--following the tone of the U.S. Treasury statement--reported the expectation that substantial reflows would occur.

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 April 29 through May 21, 1969, and a supplemental report covering May 22 through 26, 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:

> The period since the Committee last met was highlighted by the speculative flurry in the German mark, by the continuing debate over the course of the economy and the status of anti-inflationary policy, and by some dampening of hopes for an early settlement of the conflict in Vietnam. In this atmosphere our own efforts to keep the markets and the banking system under firm restraint produced tensions in the money market that led to new highs in most short-term rates and to a deterioration in the capital markets. These rate developments have been amply described in the written reports to the Committee and I will not dwell on them here. The Treasury bill rate, on the other hand--heavily influenced by technical supply and demand conditions--was a relatively stable performer. In yesterday's regular auction, average rates of 6.12 and 6.22 per cent were established respectively for 3- and 6-month Treasury bills, up 7 and 18 basis points from the auction just preceding the last meeting of the Committee.
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> The high cost of dealer financing--with the rate touching 10 per cent on one occasion at the major dealer lending bank in New York--led Government security dealers to adopt very cautious portfolio policies. Treasury bill positions have recently been running only slightly above $1 billion, while holdings of coupon issues maturing in more than one year have been cut from $1.2 billion on May 7--the day the books closed on the Treasury's May refunding--to $500 million late last week. The reduction in portfolios has been a relatively orderly process--assisted by purchases of some coupon issues for System account and by a larger volume of purchases by Government trust funds. Despite high bank loan rates, dealer financing has not been a problem recently, with money available from a variety of sources, including the extensive use of repurchase agreements by the System to provide a partial offset to the heavy drain on reserves from market factors that

took place in the interval between Committee meetings. But despite the improved technical position of the market, dealers are in no mood to stand up to any substantial selling by banks or other investors. Despite purchases by trust accounts, yields on intermediate- and long-term Governments are daily reaching new highs. Cessation of special trust account purchases and a turnaround in the need for the System to supply reserves early next month could well exert considerable additional pressure on the market.

In the corporate market yields are again approaching the all-time highs reached earlier this year, while municipals have reached the highest rate levels since the 1930's. For municipals there have been upward adjustments of as much as 30 basis points on slow-moving issues released from syndicate. With banks moving to the sidelines the municipal bond market is in a state of apprehension and is particularly vulnerable to continued monetary restraint.

As the written reports indicate, open market operations supplied a large volume of reserves over the period to partially offset a still larger drain on reserves from market factors. Given the over-all pressure on reserve positions, banks tended to bid aggressively for Federal funds and to build up reserve excesses early in the statement week. This was particularly apparent in early May when the uncertainties regarding the mark were reaching a crescendo. By May 9, bidding for Euro-dollars and Federal funds reached a particularly feverish pitch, banks borrowed heavily over the week-end--and the major money market banks wound up with cumulative excess reserves of $4 billion on Monday morning. To mitigate--at least to some extent--the extreme tautness in the money market, we felt obliged to supply reserves in some volume before the week-end, with the full knowledge that we would have to reverse course after the week-end. Once again the matched sale-purchase agreement proved to be a most useful instrument for mopping up a temporary reserve glut.

I might mention in passing that the exchange market activity described by Mr. Coombs was fully reflected in activity at the trading desk for foreign accounts. Investment of the huge influx of funds into the German Federal Bank was facilitated by the willingness of the U.S. Treasury to issue special certificates of indebtedness to the Germans, which gave us time to acquire Treasury bills from a variety of sources or which could be redeemed as funds were recycled or flowed out of Germany after the decision against revaluation was reached. Over the period total purchases of special certificates by Germany amounted to $2.7 billion, while redemptions were $2.3 billion. And over the period we bought, on balance, $2.3 billion of Treasury bills for German account, of which about half were from the market. The remainder came from sales by the System Open Market Account, by other foreign central banks which were losing dollars in support of their own currencies, by U.S. Government agencies, or through direct purchases in the regular Treasury bill auction.

Given the general atmosphere of uncertainty in the exchange markets and the intensified efforts of banks to try to coexist with monetary restraint, the usual money market indicators were not particularly good guides to action. As you know, we were well on the high side of blue book[1/] specifications for net borrowed reserves, member bank borrowings, and the Federal funds rate. The bank credit proxy, on the other hand, was a bit stronger than had been forecast at the time of the last meeting--ending up with virtually no change instead of a slight decline. There was continued evidence of bank activity to raise funds in ways that would not be measured by the proxy; if allowance were to be made for this, one would probably have to add a percentage point or two to the proxy for May, and perhaps even more for June. All in all, the net result of System operations was to make amply clear to the market that the Federal Reserve was serious about monetary restraint, but while most bankers appear to have become converts there are still lingering doubts about what will happen when--and if--evidence of the desired impact on the economy begins to show up.

Looking to the period ahead, I would heartily subscribe to the blue book statement that "the relationship among Treasury bill rates, marginal reserve measures, and day-to-day money market rates will be subject to widely variable influences in coming weeks". As you know, the forecast is for a modest increase in the bank

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

credit proxy in June, but there are risks that new bank fund-raising devices will burgeon in the weeks ahead and make our statistics even less reliable than usual. I hope we can move promptly to a systematic collection of data on the use of such devices. Money supply, however, is forecast to increase at an annual rate in a 7 - 10 per cent range in June. Assuming that the Committee will want to include a proviso clause in the directive,[1/] I would find it most helpful to get a clear assessment of the weight members of the Committee want to place on monetary aggregates as a guide to day-to-day operations.

It is clear that the period ahead is an uncertain one and market disturbances--stemming from either domestic or international sources--may break out in areas that we cannot now foresee. But such disturbances may be the necessary price for ensuring the ultimate success of the current effort to stop inflation; we have yet to see whether that can be done without creating the psychology of a credit crunch somewhere along the way.

One final word about the Treasury's position. As you know, the May refunding--involving an offer of a discounted 6-3/8 per cent, 15-month note and a 6-1/2 per cent, 7-year note to holders of May and June maturities--resulted in a larger exchange for the longer issue than the market had anticipated. Attrition, at about 25 per cent, was high by old historical standards, but lower than many market observers had anticipated and well within the Treasury's capacity to stand without necessitating new borrowing. The Treasury should not have to come to the market for new cash until sometime in July. Meanwhile, however, Government agency borrowing has been on the rise. The Federal National Mortgage Association will be pricing today two issues totaling $600 million, including $350 million in new money. The market is anticipating a new high agency rate; ideas yesterday were ranging up to 7-1/4 per cent. The Commodity Credit Corporation, in an action not generally expected in the market, will be announcing very soon an auction of $700 million of very short-term notes.

Mr. Brimmer referred to Mr. Holmes' comment that an allowance for the new ways in which banks were raising funds might add

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

one or two percentage points or more to the credit proxy for June, and to the latter's request for members' views regarding the weight that should be placed on monetary aggregates as a guide to day-to-day operations. He (Mr. Brimmer) asked about the likely consequences for money market measures of any effort to offset through open market operations the effects of the banks' new fund-raising devices. He also asked whether Mr. Holmes thought the Desk's ability to track the aggregates on a day-to-day basis had been improved recently.

In response to the first question, Mr. Holmes said he would find it extremely difficult to pinpoint the effects of particular operations of the type to which Mr. Brimmer had referred because so many other influences would be at work simultaneously. Such operations would tend to raise money market rates and to deepen net borrowed reserves, but he could not say by how much. His response to the second question was in the negative; data were not available for tracking aggregates on a daily basis, and the weekly estimates and projections tended to be somewhat erratic. It would be undesirable, he thought, to attempt to go too far too soon in using aggregates as policy guides.

Mr. Mitchell asked about the probable consequences for day-to-day rates if the Desk were given a primary instruction in terms of some growth rate in an aggregate rather than, as at present, in terms of money and short-term credit market conditions. Would the reaction in, say, the Federal funds rate be violent?

Mr. Holmes replied that that was quite possible. The funds rate probably would move above 9 per cent and perhaps reach 10 per cent. A good deal of tension had already been created in the recent period, in which new record highs were set for the funds rate and net borrowed reserves, and further increases could produce a deterioration of market psychology.

Mr. Mitchell recalled that the first evidences of the 1966 credit crunch had occurred in the market for municipals. He asked whether any new crunch might be expected to show up initially in the market for Government securities.

Mr. Holmes replied that thus far Government securities dealers had been doing a good job in managing their inventories. However, they had been helped by substantial official and foreign purchases, including German purchases of Treasury bills. But German funds could not be expected to remain invested in bills indefinitely, and their withdrawal would create pressures. As the blue book noted, various other forces were likely to be at work in the coming period--some contributing to pressures on the securities markets and some moderating them.

Mr. Mitchell then asked whether Mr. Holmes thought that the new devices banks were employing to secure funds from non-deposit sources were defeating the System's policy.

Mr. Holmes replied in the negative. However, he added, such devices did create a problem for policy in connection with the statistics used for measuring bank credit. In his judgment it would be desirable to adjust the bank credit proxy to take account of the funds banks obtained in those ways.

Mr. Daane asked for Mr. Holmes' view of the probable consequences if System policy produced widespread expectations of a credit crunch.

Mr. Holmes responded that the spread of such expectations would produce greater financial restraint; banks would reduce the rate at which they were making loans and some potential borrowers would be forced out of the capital markets. Thus, in terms of System objectives, the consequences would not necessarily be bad, although there would be a question of how far in that direction the System would want to go.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period April 29 through May 26, 1969, were approved, ratified, and confirmed.

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

Mr. Wernick made the following statement concerning economic developments:

> After trying to strike a balance among the many plus and minus indicators reported in the current weighty green book,[1/] it is reasonable, I think, to say that there has been an increase in the visible signs that monetary and fiscal restraints are beginning to take hold. To be sure, the evidence still is tenuous, and there are likely to be temporary reverses--as in new orders and other of the leading indicators for April--but the emerging pattern is generally consistent with expectations of further economic moderation.
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> Among the broader aggregates--output, employment, and income--it seems almost certain that gains in the current quarter will be smaller than in the last quarter, and that real GNP growth will continue to slow, probably to an annual rate of under 2.5 per cent. Also encouraging has been the apparent growing credibility of monetary and fiscal policies and indications that businessmen's overly optimistic expectations may be in the process of changing. Disappointing, however, has been the continued intensive upward pressure on prices and costs, the sustained momentum in output of business machinery, and the marked increase in the rate of inventory accumulation by manufacturers of durable goods.
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> The slower pace expected this quarter mainly stems from reduced gains in consumer expenditures and in outlays for fixed investment, and a likely decline in residential construction activity. Looking back now, it seems clear that growth in consumer expenditures, although bouyed recently by a decline in the saving rate, has been easing. For example, each of the rebounds in the sawtooth pattern we have seen in the quarterly changes in consumer expenditures over the past year has been smaller than the previous rebound and in the first

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

quarter the rise in consumer spending was only slightly more than half that of the year-ago quarter. The dollar volume of retail sales in April and early May was not significantly greater than in September of last year. Moreover, in real terms, sales actually have been declining since the peak reached last fall. As a consequence, new orders and output for consumer goods declined somewhat in April.

Tax increases have probably been the most important factor slowing growth in disposable income and dampening consumer expenditures. But more recently other forces have come into play; wage and employment gains have moderated somewhat, and overtime hours are down. In addition, the accelerated increases in consumer prices this year have been taking a substantial bite out of real purchasing power. As a result, in the first quarter and probably again in this quarter, the rise in real disposable income will be at an annual rate of only about one per cent--sharply down from a rate of over 5 per cent in the first half of 1968. In the past, periods of sustained small increases in real disposable income have usually led to considerable reductions in the growth of real consumption and real GNP.

In the last half of this year, forces tending to reduce growth in real incomes could be offset in part by completion of retroactive tax payments, the Federal pay increase, and expectations of a possible reduction in the surtax in early 1970. In the current situation, however, it is not anticipated that consumers will further reduce their saving rate to increase their spending.

With interest rates very high and mortgage credit less readily available, the residential construction sector has also begun to contribute to the slackening in economic activity. Three months of declines in housing starts will undoubtedly result in some reduction in residential construction expenditures this quarter. Given current monetary restraints, the downward drift in outlays should continue for the remainder of the year and help dampen somewhat the very large material and manpower requirements now existing in the construction sector.

The Administration's fiscal posture can also be considered as a favorable factor acting to slow aggregate growth. While passage of the surtax extension is still in doubt, Congressional determination to control expenditures will almost certainly assure a relatively tight Budget in the coming fiscal year. If the surcharge is maintained--which in the end, still seems the most likely bet--the budget surplus on a national income accounts basis is likely to amount to close to $5 billion at an annual rate in the second half of the year.

Turning to the critical area of business spending, we still find only scattered evidence that businessmen have started to retrench. Business fixed investment expenditures have been extremely large. Moreover, in April output of business equipment continued to rise rapidly and new orders for machinery and related equipment rebounded sharply. This sudden surge in new orders is thought to be only temporary, reflecting substantial ordering in an effort to beat the repeal of the investment tax credit which was expected to be recommended. Nevertheless, the jump in new orders does enlarge order books and in the short run helps maintain the momentum of output and shipments in the investment sector.

Prospects, however, still seem to be for a significant slowing in the growth of capital spending for the remainder of the year. The surge in fixed-investment outlays in the first quarter already has accounted for a large part of the total planned for this year. Repeal of the tax credit should tend to limit spending somewhat. With gains in output and profits moderating and more credence now being given to the efficacy of monetary policy, it seems likely that businessmen will be reassessing the amount and urgency of their spending plans as the year progresses.

Rapid inventory accumulation also has helped maintain high output levels recently. The rise in the book value of inventories was particularly large in durable goods manufacturing in February and March. As a consequence, the ratio of inventories to shipments in March was about as high as at the end of 1966, and the ratio of inventories to unfilled orders--perhaps a more significant yardstick--was even higher than in the earlier period. In contrast, the rise in the value of inventories at retail slowed in the first quarter, partly reflecting a decline in output in the auto industry as dealers' sales slowed.

The GNP numbers indicate that inventory investment in the first quarter was smaller than in the fourth quarter, apparently reflecting both a sharp but temporary drop in inventory building in January and a very large inventory valuation adjustment for the quarter. The staff projection presents a rather guarded view of future developments in this sector, allowing for only moderate rises in stock building on the GNP basis this year as final sales ease. If accumulation should turn out to be larger because of lagging sales, the subsequent adjustment would, of course, be more pronounced.

Possible problems with inventories point up the fact that achieving a smooth path of adjustment to lower rates of economic growth may well be more difficult than we are now projecting. With gains in consumer outlays sluggish, inventory accumulation could become excessive and be followed by liquidations. If, in addition, capital outlays were to rise by, say, only 8-10 per cent this year--less than we have projected--there could be a substantial downward adjustment in activity before year-end, in which case growth in real GNP could turn negative.

But this scenario overlooks a whole sequence of possible developments on the other side--such as the failure to extend the surcharge or a change in the level of hostilities in Asia. Also, any curtailment in plans for capital outlays could prove to be short-lived, given continuing strong price and cost pressures and the apparent tendency for many businessmen to look over the valley of a short, mild adjustment to a return to rapid growth rates. With the many uncertainties now clouding the economic outlook, it seems to me that the best course is to maintain a firm policy until unfolding events more clearly point to a sustained moderation in economic activity.

Mr. Mitchell asked whether Mr. Wernick thought that a slowing of the rate of growth in real GNP was a necessary prelude in the process of coping with inflationary pressures. In other words, did the current slowing of growth constitute evidence that fiscal and monetary restraint was beginning to achieve the intended results?

Mr. Wernick replied that experience--such as that of 1967--indicated that a slowing of growth tended to be followed by a reduction in the rate of price advance. While the speed of the change depended on the amount of inflationary momentum that had been built up, it seemed reasonable to expect some abatement of price pressures later in the year if the growth rate in real GNP continued to slow as projected.

Mr. Mitchell then noted that the opening sentence of the staff's draft directive asserted both that "expansion in real economic activity is continuing to moderate" and that "substantial upward pressures on prices and costs are persisting." To his mind, the first of those statements implied that the objectives of recent policy were being accomplished, but the second seemed to deny that implication--or at best merely implied that there were lags in the workings of policy.

Mr. Hayes commented that in his judgment the statement in the draft directive about prices and costs represented an accurate report of the facts on that subject, and on that basis was appropriate.

Mr. Axilrod made the following statement regarding financial developments:

> Since initiation of the recent phase of monetary restraint in December, conditions in financial markets have evolved to the point where questions should be raised about whether or to what extent there have been

changes in the significance of various commonly used indicators and measures of monetary policy, such as bank credit, money, and interest rates. A brief backward glance at over-all financial developments in the first quarter as revealed in the flow-of-funds accounts provides a good starting point for such an evaluation.

The most notable development of the first three months of the year was the very sizable volume of funds that continued to be raised in credit markets despite the virtual disappearance of banks as a net supplier of funds to the market. Private sectors in the first quarter borrowed a little less than in the fourth quarter of last year, but more than in the third quarter, and substantially more than in any preceding quarter. The absence of net borrowing by the Federal Government and agencies taken together--in fact there was a small net debt repayment--continued to be a factor, as it was in the fourth quarter, freeing funds for private borrowers.

But of key importance in the first quarter was the increased willingness shown by the public to economize on liquidity, including cash balances, at rising interest rates. Households and nonfinancial businesses in particular appear to have economized on cash in the first quarter. While some part of this may have represented financing of own expenditures by those who did not want to pay the high credit costs, a substantial portion reflected absorption by the public of marketable securities that were either not purchased by banks or were sold by banks in consequence of the sharply restricted availability of reserve funds.

Thus, households greatly increased their purchases of State and local government securities, replacing banks as the principal source of support to that market. And businesses, among others, helped absorb the very large amount of U.S. Government securities that were offered into the market by banks and foreigners. Banks, in the face of CD attrition, reduced their holdings of U.S. Government debt or purchased Euro-dollars; these Euro-dollar acquisitions in turn contributed to sales of U.S. Government securities by foreigners to finance the movement of dollars into branches of U.S. banks.

In general, the continued large flow of credit in the first-quarter period, occurring at a time of no growth in bank reserves, led to an erosion of the liquidity position of key economic sectors. This is most clear for banks, whose liquidity positions now approximate 1966 lows. But nonfinancial business corporations also appear to be experiencing a weakening in liquidity positions--as measured by the ratio of short-term assets to current liabilities. The first-quarter rise in corporate holdings of U.S. Government securities was about offset by a drop in demand and time deposit holdings; and current liabilities continued to rise. Corporate liquidity positions are likely to worsen further in the present quarter, given current credit market tightness and a continued sizable gap between capital expenditures and funds available from capital consumption and profits.

So far as nonbank savings institutions are concerned, their liquidity, too, has been eroded, although savings and loan associations appear to be in a better position than at the worst in 1966 so far as available cash and borrowing capacity are concerned; and their flexibility on the liability side is also greater. Moreover, the Federal Home Loan Banks are better prepared with cash than earlier. And, considering the mortgage market as a whole, FNMA is available in a more flexible way as a residual source of liquidity to certain lenders.

This somewhat better state of affairs than in 1966 may account for the lack of deep pessimism in mortgage lender responses to our recent survey of conditions in the residential mortgage market. I would like to point out, however, that the costs of maintaining Home Loan Bank and FNMA support to the mortgage market are rising and affecting over-all market conditions. Since mid-April these two agencies have raised, or announced, a total of $1-1/4 billion of new cash, and the weight of these offerings has been a contributing factor to the recent weakness of security markets.

I would think that the general erosion of liquidity, and particularly liquidity of banks, that occurred in the first few months of the year as large credit flows were maintained in face of no bank reserve growth explains some of the second-quarter developments. It helps explain why banks are pushing so hard to develop new-type financing arrangements, involving holding companies or instruments similar to acceptances. Banks are running out of liquid assets readily shiftable to other sectors, are understandably reluctant to sell long-term assets in a thin and unreceptive market, and are thus attempting to find new sources of funds. They are also turning more and more to the discount window and the Federal funds market. As we in our open market or discount operations attempt to moderate money market pressures generated as banks turn increasingly to these various outlets, and as the public wants to hold more liquidity, there will be, for any given level of interest rates, more bank reserve and deposit growth.

The growth in bank credit and money supply thus far in, and projected for, the second quarter in effect reflects the drying up of earlier repositories of liquidity and the consequent increased liquidity demands of the economy--not only from banks, but also from corporations and others who may be finding that liquidity has become undesirably low. It means to me, and speaking somewhat generally in view of the limited time available, that for a given degree of monetary restraint on spending we should probably expect, as compared with the first quarter, somewhat greater growth in monetary aggregates, such as total reserves, the money supply, and possibly bank credit--because, in technical jargon, the economy's demand for liquidity has shifted upward.

This explanation does not necessarily imply that the Committee needs to, or should, be content with the rates of monetary growth projected for June and the second quarter as a whole. There is some danger that the Committee may be supplying even more reserves and cash than is consistent with a slowing of inflation, recognizing that in June some cash will be supplied to private sectors in any event through Treasury cash debt repayment. While recognizing the danger, there are reasons to think the second-quarter surge in money supply, and in a degree the pick-up in bank credit, is partly temporary--the chief reason being the very considerable corporate tax payments that were and still have to be made in a period of very low over-all liquidity. And it has to be recognized, as Mr. Wernick pointed out, that the economy appears to be in the process of slowing further. Nevertheless, to guard against over-supplying reserves relative to shifting demands, it seems to me to have been a desirable hedge to supply reserves reluctantly and to permit money market and other interest rates to move up in the process, as has happened recently.

I would not, however, suggest substantial further increases in money market rates in the period ahead, unless the total of bank demand and time deposits shows signs of rising rather more than projected. We have no reason to think, as of now, that recent and current credit conditions will not lead to a slowing of the economy. And though the highly erratic money supply measure may spurt, total bank deposits in June are projected to rise, if at all, quite modestly indeed--particularly when account is taken of the mounting pressures on liquidity in a period when the mid-June tax date and the mid-year interest-crediting period will provide critical tests for the stability of various credit markets. Discretion is not always the better part of valor, but under current conditions it may well be so for monetary policy in relation to the sensitive and extremely taut conditions in our credit markets.

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

Nothing that has happened in recent months alters in the least the pressing need for a better structure in the U.S. balance of payments. Reasonably orderly functioning of the international monetary system is becoming far too dependent on capital flows of various sorts that cannot be counted on to continue. We need a much larger U.S. goods and services export balance. To get it we must have cooperative action from a number of important countries to reduce their current account surpluses. And we must greatly slow our own inflation of prices and income.

If we are to apply the word "eternal" to anything in the present economic scene, what I have just said surely qualifies as an eternal verity. I should like to turn now to a situation which may or may not remain eternal until Germany's elections next September. One of the most striking features of the recent crisis was the unprecedented size of the movement out of dollars into marks. During a 20-day period to May 13 possibly well over $2 billion worth of marks were acquired by companies and others, here and abroad, who had been holding dollar assets here or in the Euro-dollar market or who borrowed for the purpose either here or from Euro-dollar banks. The figures may look small in the U.S. economy, but in the exchange market these are massive amounts.

Can we still say that confidence in the dollar remains unshaken, or that "the dollar was unaffected"? This movement was far larger than anything that occurred around the time of the 1961 German mark revaluation. In those days we trembled when we imagined future crises of the size we have now sailed through.

What has happened since 1961, and what is there in the present situation, to lull our apprehension? Three things are fairly obvious, but still worth mentioning. First, in a short-run perspective our net reserve position was looking healthy enough for many months before this episode blew up--thanks to the pull of our extraordinarily high interest rates. Second, there is widespread appreciation of the fact that a German mark revaluation is something the world needs; for this reason the relative strength of the mark has looked like absolute strength of the mark, not absolute weakness of the dollar, nor for that matter, to many people, like absolute weakness of any currency. Third, there has been a change since 1961 in thinking about gold. The central banks realize that the world's monetary stock of gold is too small, and the United States gold stock is too small, for countries to scramble over each other for gold any more. The two-tier system has successfully defused the gold bomb for the moment. The private demand for gold and the forthcoming supply being what they were, there was no rise in the dollar price of gold during the recent crisis. Since many people consider that there is no way of measuring absolute weakness of the dollar except by the gold price, they have to conclude that the dollar was not weak.

For several years the world has been nearly, but not quite, on a dollar standard. This results from a certain degree of mutual trust and forebearance, and there is certainly no point in upsetting or provoking Europeans by telling them they are on a dollar standard. When our interest rates fall, it may become hard to hold the system together and avoid proliferations of controls and segmentations of the world economy. If the system can be held together, to keep it in order means avoiding excessive changes in price levels and exchange rates, and it also means avoiding insufficient changes in exchange rates when changes become necessary.

In concluding my remarks I should like to take a few minutes on some technical implications for U.S.

monetary developments that grow out of the use of the dollar as a reserve currency.

First: The German Federal Bank's huge reserve gain in the first half of this month was not used to buy gold; much of it has been put into U.S. Treasury bills. Thus, although private funds were draining out of the U.S. financial system to move into German mark assets, central bank funds were being reinjected at another point in the U.S. financial system. This was a mechanism tending to widen, or maintain, the spread between day-to-day money rates and Treasury bill yields.

Second: A minor part of the German central bank's large reserve gains resulted from private movements out of sterling and French francs, part of the settlement of which we financed by Federal Reserve swaps. To offset the potential additions to member bank reserves when the Federal Bank used the swap proceeds transferred to it to buy Treasury bills, the Desk bought fewer bills than it otherwise would have.

Third: Earlier in the year, and again in the past two weeks or so, U.S. banks have been increasing their liabilities to foreign branches, which in turn have attracted funds from banks and nonbanks in other countries, on a very large scale. When this happens, we adjust the bank credit proxy by adding to its increase the increase in the U.S. banks' reserve-free external liabilities. This gives us a better measure of the change in U.S. bank assets. But the foreign central banks losing reserves at such a time tend to sell Treasury bills into the market. Thus the addition to the banks' assets (or avoidance of asset liquidation) is accompanied by a withdrawal of credit previously supplied to the domestic economy by the foreign central banks.

One final footnote on the most recent developments in U.S. foreign trade. We have learned that in April, when both exports and imports were well above normal as they caught up after the strike delays, the export surplus was still very small, and somewhat smaller than the monthly average we are looking for in the second quarter. It will be at least another month before we can form a fresh estimate of the underlying trends.

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

Despite some statistical signs of a less rapid pace of advance in April, it would be premature to conclude that an adequate slowdown in the economy is at last under way. We must, I think, bear in mind the frequently erratic nature of month-to-month developments, as well as the prevailing deeply-embedded inflationary psychology which could easily bring a reversal of these recent more moderate tendencies. On balance, I would still expect GNP to continue its relatively rapid advance, with consequent difficulty in getting the price-cost spiral under control. The latest data on consumer and industrial wholesale prices, as well as on wages and unit labor costs, are anything but encouraging. I am more than ever convinced that a business slowdown of some considerable duration may be needed if we are to make any real progress on the cost-price front.

Our balance of payments position, already shaky enough because of the virtual disappearance of our trade surplus, has been badly damaged anew by the tremendous flow of speculative funds into Germany. Apparently about half of the total flow into Germany came from the United States. While some of this will no doubt be reversed, it seems likely that a goodly portion will remain in Germany in continuing expectation of a mark revaluation. The market seems to interpret the German Government statement that the mark parity will be maintained "for eternity" as meaning that it will probably be maintained for a few months at most. Other important factors working against our balance of payments have included a sharp shrinkage in purchases of American stocks by foreigners and a sharp drop in "offshore" bond issues. And any hope of a real recovery in our trade balance in 1969 appears to have vanished.

The underlying liquidity deficit for 1969 to date probably totals around $4-1/2 billion, so that even if we should manage to stay in equilibrium for the rest of the year, which may be too much to expect, we would end up with an underlying deficit $2 billion higher than that of 1968. Even our vaunted official settlements for 1969 to date disappeared with the outflow of funds to the German Federal Bank. Under these conditions the dollar may become increasingly vulnerable to exchange crises affecting other major currencies. There is therefore every reason, from the standpoint of our international position, to adhere strongly to an anti-inflationary monetary policy.

Viewing Federal budgetary developments, we can find satisfaction in the strong Congressional resistance to Federal spending increases and the prospect of a sizable surplus in the coming fiscal year. On the other hand, the Administration's tax proposals, coupled with Congress' apparent reluctance to renew the surcharge even on the basis of a reduction to 5 per cent as of January 1, has led to growing skepticism in financial circles as to how firmly the Government is likely to persevere in anti-inflationary fiscal measures as soon as any real softening begins to show up in the economy. We may before too many months have to contemplate another period when too much of the burden of effective Federal economic influence is left to monetary policy.

As usual, it is hard to reach a judgment on the appropriateness of recent credit developments. For the first five months of 1969--including estimates for May--the near-zero growth of the proxy seems about right, coming after such a long period of very excessive expansion. I believe we should certainly take into account the very rapid growth of direct credit granted outside of the banks, as suggested by a variety of indicators including the first-quarter flow-of-funds data. The total flow of credit to the private domestic nonfinancial sectors grew at the high annual rate of 10.2 per cent, only a little lower than the record rate of the fourth quarter. Turning to the money supply, we find a growth rate for the year through May of about 3 per cent, which seems ample and perhaps even a bit excessive. The current June estimate of a 7-10 per cent growth rate may be pretty unreliable, but if it turns out to be accurate I would find it highly disturbing.

Bank loan demand has continued very strong and will probably remain so. One result, of course, is growing pressure on the municipal bond market as the banks seek to improve their depleted liquidity. The thrift institutions, which have done surprisingly well in the face of very high market interest rates, are also experiencing greater pressure. We cannot rule out the possibility of another credit "crunch", especially in the municipal market; but this is a risk that must be taken in the light of our major objectives. I hope that the banks will cooperate more effectively than they have to date in rationing credit so as to minimize these market pressures.

With respect to open market policy, I think we should try to keep the growth of money and credit at relatively low rates and with this in mind should maintain at least the existing pressure on the banks. This would probably suggest borrowings of from $1.1 to $1.5 billion and net borrowed reserves of from $1.0 to $1.3 billion. The erratic performance of the money market, due largely to international factors, has diminished the usefulness of the Federal funds rate as an operating guide. We might perhaps expect a funds rate range of 8 to 9 per cent and a bill rate range of 5.9 to 6.2 per cent. The Manager should be given wide latitude to deal with any money market disturbances, but without sacrificing our major objective of restraint.

For the time being I see no need to change the discount rate. I suppose we must maintain the present ceiling on CD rates in order to preserve a psychology of very firm restraint among the banks. In the longer run, however, I feel that we should de-emphasize Regulation Q as a credit instrument, having in mind how a restraint of this kind tends to distort institutional arrangements and automatically fosters new means of evasion. While the best way to relieve undue pressure on the Euro-dollar market might be to lift Q ceilings, we probably must seek another solution under present circumstances. I would hope the Board would promptly eliminate the offset against deposits subject to reserve requirements gained through one-day Euro-dollar borrowing. And in view of the real danger of a crisis in the Euro-dollar market, it would be desirable to develop specific plans that could be applied promptly to reduce the pressure brought to bear on that market by American banks if the pressure should become unduly severe.

As for the directive, I would prefer to keep the wording "real economic activity has moderated only slightly" in the opening sentence, in order to stress the fact that there has not been enough moderation to achieve the objectives of policy. The language of the staff's draft conveys the impression that steady progress

> is being made, and I am not sure that it is. In the second paragraph I think our stance would be improved if we substitute the words "maintaining continuing pressure on" for the words "maintaining prevailing firm conditions in." With regard to the proviso clause, I believe we have to treat the credit proxy with extreme caution in the present situation. Some allowance will have to be made for the use of new fund-raising devices by our banks. If in June bank credit--somehow measured--appears to be increasing at the upper end of current projections, and if the money supply appears to be developing as now projected, I would consider it appropriate for the Manager to shade operations in the direction of greater restraint.

Mr. Francis said that in his opinion the general course of Federal Reserve influence during the past several months had been about right. Since the Committee adopted a firmer policy last December the money stock had gone up about a $1 billion or at about a 2 per cent annual rate. That was in sharp contrast with the 6 per cent rate of the preceding two years. Similarly, growth rates in Federal Reserve credit, total member bank reserves, and the demand deposit component of money had slowed.

Mr. Francis noted that according to the blue book the staff expected money to rise at about a 7 to 10 per cent annual rate from the May average to the June average. He felt that such a rise in money would be inappropriate, and that steps should be taken to resist it. He inferred that the rapid monetary expansion was expected to result from accommodating strong credit demands at existing market interest rates. Such a procedure had led the Committee to mistakes in the past.

Mr. Francis remarked that total spending, according to latest available data, had continued to rise excessively, maintaining the inflationary pressures. However, his staff's analysis indicated that those were mainly lagged effects of monetary developments several months ago. If monetary restraint continued, clear evidence of a beginning towards reducing the excesses should be forthcoming with a few months.

Mr. Kimbrel observed that Floridians were noted for their habit of looking at the bright side of things. Thus, it was noteworthy in itself when one heard from two economic services in Florida, as the Atlanta Reserve Bank had recently, that there had been a tapering off--if not a leveling--in economic activity there. In addition, coming from Florida that was cheering news indeed at the present time to those who were looking hopefully for signs of diminishing economic pressures. It might be somewhat typical of what was happening elsewhere in the Sixth District. Early estimates suggested that total nonfarm employment in the District stopped rising in April for a while at least, and unemployment might have risen slightly.

However, Mr. Kimbrel continued, eager as he might be to detect evidence of decreasing economic pressures, what had happened in the District recently seemed to him to be no more than the possible start of a slowdown. For example, automobile sales in the District had increased substantially following a decline in March, and there had been a significant increase in automobile loans extended. He found that the slowdown in Florida could be traced partly to a construction slump related chiefly to labor troubles.

Mr. Kimbrel reported that District banks had sharply accelerated their lending in April and reduced their investments. Most of the loan growth took place at the large banks. Largely because of additions to savings accounts other than passbook accounts at country banks, time and savings deposits for the District continued to expand. In early May member banks reported a slight moderation in lending, a further decline in investments, and a sharp increase in borrowings from the Federal Reserve Bank of Atlanta and in the Federal funds market.

Mr. Kimbrel had no doubt that many member banks in the Sixth District were under increased pressure, although perhaps not to the extent experienced by banks in money market centers. The evidence was not conclusive, however, that those pressures were being transmitted sufficiently to the economy generally.

The Board's staff had very ably reviewed the evidence of a gradual slowdown on the national scene, Mr. Kimbrel said. If the slowing in GNP already experienced were to continue, it would be gratifying. It was perhaps too early to expect to have more evidence that price pressures were being reduced. On the whole, however, he thought it fair to conclude that the slowing in the sectors of the economy already affected would have to continue, and extend to others as well, before the Committee could be satisfied that its policy was having the desired effect. This was no time, in his judgment, for relaxation.

Mr. Kimbrel thought the principal problem at the moment was that of translating the desire for exerting continued pressures into policy execution. It seemed to him that there was more danger that the Committee would not exert the required pressures if it focused its attention on rates rather than on reserves and total bank credit. He would, therefore, prefer to have the directive formulated in terms of total bank credit and reserves. However, a directive stated in terms of the money market conditions set forth in the blue book[1/] would be satisfactory as long as it were clearly understood that operations would be modified if during the period there were any deviations on the up side from the projected annual rate of growth in the bank credit proxy.

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1/ The blue book passage referred to read as follows: "Assuming no change in monetary policy, and recognizing the probability of large and varying money market flows apart from System operations, money market conditions may encompass a Federal funds rate continuing to average around 8-1/2 per cent, member bank borrowing in a $1 to $1-1/2 billion range, and net borrowed reserves generally a little over $1 billion. The 3-month Treasury bill rate could fluctuate widely, but may generally continue to be in a 5.90 - 6.20 per cent range. An increase in the bank prime loan rate would enhance the likelihood of the bill rate moving toward or above the upper end of this range."

Mr. Bopp observed that at some point in any period of restrictive policy, it became necessary to reduce the degree of restraint. For the past several meetings, he had asked himself whether the time was ripe, and today he found himself again weighing the pros and cons.

There were several factors arguing for less restraint, Mr. Bopp said. By almost any measure, policy so far this year had been highly restrictive. Financial institutions and money markets were clearly registering signs of strain, and a seasonal demand for funds in June would exert further pressure on them. In addition, scattered signs were beginning to be seen of a slowing down in the pace of economic activity.

Locally, for example, the last several surveys of the business outlook conducted by the Philadelphia Reserve Bank had hinted at the prospect of moderation in economic activity, Mr. Bopp noted. The May survey gave further support to that prospect. Relatively few manufacturers in the region expected to hire additional employees in the months ahead. The number of business executives expecting increased business six months ahead had dropped from nearly 60 per cent last month to just under 35 per cent this month. Nevertheless, most of them did continue to expect prices to rise.

At the national level as well, Mr. Bopp continued, signs were appearing that the restrictive policy was beginning to bite.

The increases in industrial production and personal income during April were consistent with a picture of emerging moderation. The sharp rise in business inventories during February and March suggested that final sales during the first quarter might not have been as large as had been thought.

But arguing against any letup in the policy of restraint was the fact that the economy was still undeniably strong despite those scattered and tentative signs of easing, Mr. Bopp said. Prices continued to rise and the inflationary psychology was deeply imbedded. Labor markets remained exceptionally tight and continued to exert upward pressure on unit labor costs. Spending for plant and equipment would be clearly stimulative during the next two quarters, and sizable Federal pay increases would occur in the third quarter. The signs of moderation which were now beginning to appear in the real economy were not yet sufficiently numerous or persuasive to prompt any relaxation of restraint.

Easing prematurely and excessively would carry high costs indeed, Mr. Bopp observed. Therefore, he continued to believe that the present degree of restraint should be maintained a while longer. During the next four weeks, the Desk should be instructed to keep growth in the bank credit proxy at the lower end of the range projected in the blue book. A change of that order, according to the blue book, would be consistent with no change in money market rates. However, given the tightness that already prevailed in the money market, that forecast might not materialize. If rates did move up, the Committee should be prepared to accept that as an unavoidable cost of keeping the pressure on. The Desk, however, should be given discretion to prevent disorderly markets.

Mr. Bopp considered the draft directive appropriate.

Mr. MacDonald commented that for the last two quarters the rate of growth in real economic activity had been below the potential rate at which the economy was capable of expanding, and the Cleveland Reserve Bank's staff expected that that situation would continue throughout the remainder of 1969. In such an environment, inflationary pressures and expectations should give way slowly, but as yet there were few signs of accomplishment on the price front.

Mr. MacDonald reported that expectations of reduced real growth coupled with continued strong inflationary pressures proved to be the nearly unanimous forecast of a group of 40 Fourth District business economists who attended the regular quarterly meeting of that group at the Cleveland Reserve Bank on May 16. In general, the business economists' outlook for the remainder of 1969 was somewhat less bullish than that of the Bank's own staff or of the Board's staff. The median forecast of the group was for an increase in GNP in current dollars of $15 billion in the second quarter of 1969, $14 billion in the third quarter, and $11 billion in the fourth quarter, with most of the increases occurring in prices rather than real output. The view that real economic activity would progress at a slower pace in the second half of the year was also reflected in the group's forecast of industrial production. The index was expected to rise by one point in both the second and third quarters of 1969 and then to level off in the last quarter. The median forecast for industrial wholesale prices was for an increase of one index point in the second quarter, followed by an increase of about one-half a point in each of the next two quarters.

With regard to activity in the various sectors in the economy for the remainder of the year, Mr. MacDonald continued, personal consumption expenditures and government purchases of goods and services were expected to rise at fairly steady rates, while gross private domestic investment was expected to level off, following the sharp spurt of the late 1968-early 1969 period. Net exports--virtually zero in the first quarter--were expected to reach $2 billion in the fourth quarter, offsetting some of the downward pull on over-all quarterly increases effected by other components.

Mr. MacDonald said the business economists unanimously supported the current degree of monetary restraint. Their remarks had indicated that they could see no evidence to suggest that the Federal Reserve should move to a tighter monetary position; on the other hand, they saw no evidence that the System should move towards the side of less restraint.

Mr. Sherrill said he believed that some progress was beginning to be shown in restraining the real economy and that the existing degree of restraint was about right. However, he thought it was likely to prove difficult to maintain the present restraint in view of the inventiveness of banks in finding new ways to raise funds. It would be desirable, in his judgment, to resist bank efforts to increase their liquidity by such devices.

The draft directive in the form submitted by the staff was acceptable to him, Mr. Sherrill continued. He thought the Desk should pay careful attention to the bank credit proxy and the money supply. Growth rates at the upper ends of the ranges projected for June would be dangerous, particularly since as presently calculated the proxy understated the resources actually available to banks. Accordingly, if those upper limits were approached he would favor shading money market conditions in the direction of firmness.

In sum, Mr. Sherrill observed, he thought that the Committee's present policy was appropriate but that great care would be needed to make sure that it was maintained.

Mr. Brimmer said he would first express his judgment on Mr. Holmes' question regarding the Committee's attitude toward use of monetary aggregates as guides for day-to-day operations. He (Mr. Brimmer) would hope that under present circumstances the Manager would not be hasty to change the way in which decisions on open market operations were made. While he appreciated the need to pay close attention to some aggregates, he noted that that was already being done. He would not want to see the Committee adopt the money supply or any other single aggregate as the primary target for monetary policy, and he certainly would not want to have the Committee call for growth in an aggregate at a rate within some narrow band.

Nevertheless, Mr. Brimmer continued, from the projections given in the blue book and Mr. Holmes' comments today one could conclude that the inventiveness of bankers in finding new ways to raise funds was likely to lead to a higher growth rate in bank credit in June than it would be desirable to maintain. The blue book projected the change in the proxy in June at an annual rate in the range of -1 to +3 per cent, but noted that Euro-dollar borrowings could add another percentage point or two; and Mr. Holmes had indicated that allowance for funds raised through other nondeposit sources could add another two percentage points or more. While, strictly speaking, those elements were not necessarily additive, their sum implied an upper limit of 7 per cent in the projected growth rate.

Accordingly, Mr. Brimmer remarked, he would support Mr. Hayes' suggestion that the second paragraph of the draft directive be amended to call for "maintaining continuing pressure on" money and short-term credit markets. The question had been raised as to how far the Committee could go in maintaining pressure without creating expectations of a crunch. He was not overly concerned about that risk. Obviously, the Committee would want to avoid disorderly markets, but he would resist the notion that it should ease the stance of its policy because of bankers' fears of a crunch. In adjusting to monetary restraint banks had an alternative to selling coupon issues at substantial losses; they could reduce the rate at which they were making loans.

Turning to the first paragraph of the directive, Mr. Brimmer said he did not see much difference between the staff's draft language for the opening sentence and Mr. Hayes' suggestion. He thought both statements were accurate and that the choice between them was a matter of taste. In contrast, Mr. Hayes' proposal for the second paragraph struck him as an important improvement.

In a concluding observation, Mr. Brimmer said he hoped the Committee members realized that no Government measures were in prospect at present to help improve the U.S. balance of payments for 1969. In addition to the program changes already made, which were likely to contribute to a worsening on capital account, the Commerce Department was planning other, as yet unannounced, changes in its program that would add to the worsening. He saw no reason to be even as optimistic as the authors of the green book were.

Mr. Maisel said he thought, just as he had two months ago, that there was but little chance that a careful search for straws in the winds of change in the real economy would furnish any vital information needed to formulate monetary policy at this time. The real economy was strong; demand was excessive. However, the lags were long between changes in monetary policy and their impacts on total spending, and particularly on prices and employment. Therefore, attempts to formulate monetary policy based upon current observations of spending levels most probably would be wrong. Instead, he would urge again that the Committee look primarily to the financial markets and particularly to flows in total bank credit in formulating policy.

What the Committee saw in those items should cause it concern, Mr. Maisel observed. While one had to recognize that every period was unique, one could see similar periods to the present in the past. Clearly, the System appeared to have removed a great deal of liquidity from the banking and financial system. As a result, the situation must be a good deal closer to disorderly markets and to financial hardships and distress in particular markets than it was six months ago.

If one compared the projected changes in the credit proxy for this half year to those which occurred in 1966, Mr. Maisel continued, one found the rate of decline in credit expansion much sharper now than it was at any time in 1966. That appeared clear even when Euro-dollars and other new types of bank liabilities were included. It was also true if the deposits of other financial institutions were included, although they had lost funds more rapidly in 1966 than so far this year. The only time in 1966 in which more rapid change could be found in any aggregate was for the months of May through August, when the narrowly defined money supply had decreased more rapidly than recently. But he personally would attach only slight importance to that fact. A more important fact was that, compared to the February projections, while spending had been somewhat higher this half year, the expansion in bank credit instead of rising in a 4 to 5 per cent range had been negative--even including Euro-dollars.

Clearly, Mr. Maisel remarked, no one could be certain as to what backlog of liquidity existed last November, nor as to how resilient the credit system was. One did know, however, that a rapid rate of decline in any economic aggregate could not be maintained too long. Such declines could proceed for a period in which the initial stock or backlog was used up, but eventually problems arose. For the past six months the Committee had been cutting into the large stock of credit liquidity existing at the start of the period. While up to now it might primarily have been cutting away excess fat, the danger that it would carve into vital sinews of financial flows increased day by day.

Mr. Maisel observed that he recognized, of course, that some members of the Committee might believe that a credit crunch would be valuable. It would demonstrate who was master in the current situation. Personally, however, he believed it would be a mistake. The Federal Reserve should not over-react. It should maintain its position in a general Governmental program aimed at reducing demand across the board, and not impose far greater and more dangerous restraint on those who happened to be debtors or to need credit to operate their businesses. As a result, he still believed that a decision to try for or to accept a credit crunch would be a self-defeating decision, because a crunch was a sign of maldistribution of money and credit.

Mr. Maisel thought also that all members of the Committee recognized that if it now slowed the rate at which it was decreasing expansion it would find it much easier in the future to move smoothly to whatever growth in credit was necessary. All those concerned that the Committee should not give a false image of its determination to disinflate should want a smooth transition back to a level of credit growth that would be viable. The way to insure such an orderly change was to start now by keeping the rate of growth in the credit proxy moderate.

As a result, Mr. Maisel concluded, in this coming period the proviso should be based upon a level of credit that would facilitate getting back toward a sustainable rate. It would be desirable for the credit proxy to grow in June at about the 3 per cent rate that it had averaged in April and May. Therefore, he would like a proviso with a range of plus or minus 2 per cent from that desirable level, rather than from the range predicted in the blue book. It would also appear that as conditions approached a sphere where market difficulties were likely to appear, interest rates were likely to carry a greater message than in many other periods. That meant that they should be watched carefully by the Manager, particularly if higher rates were accompanied by only small increases in the proxy.

Mr. Daane recalled that when Allan Sproul was a member of the Committee he had often observed that monetary policy had to be made on the basis of facts and figures that were not there. That was particularly true today; the available statistics were not good enough to permit projecting future developments with confidence. As to Mr. Mitchell's earlier comment regarding the first sentence of the directive, he (Mr. Daane) would say that if expansion in real activity was moderating sufficiently some abatement should be evident in the pressures on prices and costs, at least from the side of aggregate demand.

His own view, Mr. Daane continued, was that some cooling off of the economy probably was in fact under way and that the degree of stringency the Committee had aimed at in financial markets--and in the banking system in particular--was finally being achieved. At the same time, he shared the views that not enough moderation in activity was being achieved to abate inflationary forces, and that it was important that there be no slippage in the prevailing degree of financial stringency. He wanted to make clear that he was not seeking a credit crunch. Nevertheless, he agreed with those who thought that the consequences of spreading expectations of a crunch--however defined--would not all be bad. Indeed, such expectations might be an essential part of the process of getting the degree of stringency in financial markets that was required if the objective of abating inflationary pressures was to be achieved. He felt strongly that in both the domestic and international areas the present was a critical time, and that the stakes were very high.

Accordingly, Mr. Daane said, he agreed with Mr. Hayes that the language of the second paragraph of the directive should be strengthened. He would be willing to go a bit further than Mr. Hayes had suggested, and call for operations "with a view to maintaining firmer conditions" in the money and short-term credit markets. However, he could accept Mr. Hayes' suggested language if it were interpreted to mean that there would be absolutely no slippage; that errors, if any, would be on the side of restraint; and that no one would be given the impression that the banking system was going to be bailed out because of a fear of a crunch on the part of the Committee.

Mr. Mitchell said he would accept Mr. Axilrod's analysis of the problem and his prescriptions, including his comments on valor and discretion. As to Mr. Holmes' question concerning the weight to be given to aggregate variables, he personally would prefer the use of an aggregate target at this time because of the difficulties of specifying marginal reserve targets. He could not say what level of member bank borrowings would be appropriate now--perhaps the proper level was $1-3/4 billion--and he did not know what other conditions could be expected to be associated with such a level of borrowings.

Among the various aggregates, Mr. Mitchell continued, he thought $M_1$, with all of its deficiencies, was to be preferred to either $M_2$ or the bank credit proxy, and he would favor an annual growth rate for $M_1$ in June in the range of 5 to 7 per cent. In his judgment the credit proxy was of generally limited usefulness because of the shifts of funds that occurred between banks and nonbanks. Under current circumstances it was extremely deficient; it could, for example, remain unchanged despite rapid monetary expansion.

As to the risks of a crunch, Mr. Mitchell said, while he did not think the Committee should try to avoid creating difficulties for any individual bank he would be concerned if markets for Government securities and municipals began to border on the disorderly. There was some question in his mind as to whether those markets actually were disorderly in 1966, but there was no doubt that they were close to it. He agreed with Mr. Maisel that it would not be desirable for the Committee to create such conditions.

In a concluding comment, Mr. Mitchell said that once past June and the pressures expected around the tax date, monetary policy could be made a little tighter if that appeared desirable then. For the time being, as he had indicated he would favor focusing attention primarily on the money supply.

Mr. Heflin reported that business in the Fifth District apparently continued to move ahead, with somewhat fewer signs of moderation than were present in the national data. The Richmond Reserve Bank's most recent survey suggested current increases in both general retail sales and automobile sales and an improved orders situation in all manufacturing lines except textiles. Residential building outlays appeared to be slowing, however, and while business expectations continued on the buoyant side, he was beginning to hear isolated reports of cutbacks in capital spending plans.

With respect to the national economy, Mr. Heflin said, the April data presented more signs of moderation in the expansion than had been seen at any time this year. Moreover, taking a somewhat longer view, the decline in the rate of real growth over the past three quarters was, he thought, impressive. The annual rate of less than 3 per cent indicated for the first quarter could hardly be considered excessive in a more normal expectational climate. Yet he believed it was entirely premature to judge from the latest statistics that any significant headway had been made in returning the economy to a sustainable growth path. Apart from the possibility of aberrations in the statistical data, it seemed to him that the Committee continued to face strong inflationary pressures and a pattern of business expectations that was almost certain to encourage increasingly intensive use of whatever money and credit it might make available.

Thus far, financial markets appeared to Mr. Heflin to have accommodated quite well to the extremely tight policy posture the System had been able to establish over the past few months. Recent swings in bond yields and stock prices seemed to have been related primarily to expectational shifts associated with Vietnam peace moves, although the high cost of short-term funds and rumors of another prime rate hike also had been important factors. His impression was that the restrictive posture over the past five-and-a-half months had begun to squeeze liquidity positions in the business community as well as in the banking system. That could, of course, help to cool down inflationary expectations. But he thought the Committee should recognize that, in the kind of expectational climate it faced, the liquidity squeeze could also accelerate business loan demands and sharply aggravate upward pressures on rates. In brief, it seemed to him that a credit crunch remained a serious possibility in the absence of an early break in the Vietnam negotiations.

In any event, Mr. Heflin said, he thought the Committee had to take that risk if it hoped to return the business advance to a sustainable path. Considering the over-all domestic picture, he did not believe any easing could be justified at this time. On the other hand, he did not see anything in the latest economic data to warrant a further tightening move, and it seemed to him that current conditions in both the financial markets and the international exchanges cautioned against such a move. He favored maintaining about the present degree of restraint in the market, but would not like to see the growth in bank credit diverge very much from the staff projections. He favored the changes Mr. Hayes had suggested for the directive.

Mr. Clay observed that there were some indications of moderation in the growth of aggregate demand and economic activity that might prove to be forerunners of the abatement of price inflationary pressures. As yet those were only preliminary and tentative steps in the sequence of developments that was required to reach that goal in an orderly fashion. At the same time, costs and prices continued to rise at a disturbing pace, and wage settlements being made now were going to put upward pressure on prices for many months ahead.

Mr. Clay remarked that if the necessary sequence of developments was to work its way through the economy to produce a slowdown in cost-price increases, monetary policy restraint, along with fiscal policy restraint, had to be firmly maintained. Any relaxation of policy at this stage would likely be followed by an acceleration of the wage-price spiral. It also was important to break the expectations of continuing price inflation and to remove doubts as to the resoluteness and effectiveness of public economic policy. In the final analysis, however, that also would require evidence of the impact of policy and its progress toward the goal sought.

For the time being, it seemed best to Mr. Clay to continue monetary policy essentially in its present posture. If that policy was firmly maintained, its impact should put the banking system under increasing pressure over time. In view of the unusually severe situation in the credit markets, however, one could not rule out the possibility of some contingency arising that would necessitate a temporary modification of open market operations. Money market conditions associated with a continuation of current monetary policy as set forth in the blue book appeared logical. Those conditions included a Federal funds rate averaging 8-1/2 per cent, member bank borrowing of $1 to $1-1/2 billion, net borrowed reserves generally a little over $1 billion, and a 3-month Treasury bill rate generally in a 5.90 to 6.20 per cent range.

The draft of the economic policy directive appeared satisfactory to Mr. Clay.

Mr. Scanlon reported that expectations of further rapid price inflation on the part of most Seventh District consumers, businessmen, and investors apparently had been influenced very little thus far by monetary and fiscal policies designed to restrain excess demand. On the other hand, some observers saw evidence in recent trends in broad measures of activity that restraint was gradually taking hold. They believed that a slower growth in spending would be more clearly evident in the second half, assuming that existing policies were not relaxed prematurely. He subscribed to that latter view but recognized that he might be giving excessive weight to the fragmentary evidence of easing pressure on resources. Except for centers producing passenger cars, the intense demand for labor appeared to have continued unabated and in some areas, including Chicago, demand appeared to have strengthened further.

Prices continued to rise rapidly, Mr. Scanlon said. Nonferrous metals and products containing those materials were in the forefront, but the price uptrend continued to be broadly based. Orders booked by most equipment producers in the District reflected the capital spending surge. Steel firms were raising their sights on output for 1969. Production of 1969 model autos would end in early July--one or two weeks earlier than usual--possibly reflecting the abundant inventory of most models and makes. Some lines would be shut down before July 4. Truck sales continued excellent.

In the banking area, Mr. Scanlon found little indication of any slowdown in loan demand. All of the Seventh District banks in the lending practices survey reported that loan demand was as strong or stronger than three months ago, and only two reported that they expected any weakening in the next three months. All of them claimed to have tightened their lending practices in the past three months. He believed they were turning down many loans, but that the old story still controlled--if they did not make the loan their competitor would make it and they would lose the account. A preliminary tabulation of early reports on loan commitments showed a decline in unused commitments at District banks of 4 per cent between January and April. "Lines of credit" showed the greatest decline. Recently, some large firms had begun to draw on lines that seldom had been used in past years. Unused commitments increased for "term and revolving credit," "mortgage warehousing," and "residential mortgages."

Mr. Scanlon noted that business loans had declined on balance, but only because of the transfer of loans to foreign branches. Real estate and consumer loans had continued to show moderate increases. Meanwhile, the major banks in the District continued to show very deep basic deficit positions, with generally heavier reliance on Federal funds and somewhat less reliance on Euro-dollars.

As had been pointed out, Mr. Scanlon said, except for total reserves, measures of money and credit indicated a reversal of the abrupt rates of expansion of April. Taking April and May together, the credit proxy was about in line with the Committee's objectives but money supply showed a fairly rapid growth. The monthly swings in the aggregate series appeared larger than was either necessary or desirable, even if efforts to stabilize them were to result in somewhat greater short-run movements in interest rates. That question certainly merited further study and probably merited experimentation.

As for policy, Mr. Scanlon remarked, if it were possible to pinpoint figures he would favor operations designed to achieve growth in money at an annual rate of about 2 per cent and some growth in bank credit but at no more than a 4 or 5 per cent rate. The projection for June was for a much larger rise in the money supply. In view of the efforts of banks to develop means of circumventing the intent of Regulations Q and D, and the effects of those developments on the bank credit proxy, a proviso clause geared to growth of the credit proxy might not provide the best approach to open market operations under current conditions. Possibly along with other policy changes, the Desk should undertake to thwart the projected growth of money supply in June.

Mr. Scanlon observed that the demand for credit exceeded the Committee's expectations in both April and May, as indicated by the larger-than-projected growth of money and credit in April and the greater-than-expected rise in interest rates--except bill rates--in May. If the projected growth of money occurred in June or if the credit proxy were to rise more than was projected, the over-all picture for the second quarter would not appear to be one of vigorous resistance to inflation--particularly in the view of the System's critics.

Therefore, Mr. Scanlon said, he would press firmly, fully expecting to hear shouts of crunch and crisis, even though the situation might not be that critical. Unfortunately, that shouting apparently was part of the process necessary to convince the public that monetary policy meant business. As to the directive, he agreed with Mr. Hayes' comments with respect to the proviso clause.

Mr. Galusha reported that in the Ninth District only the construction sector had given fairly convincing signs of a leveling-off in real activity. Employment, housing permits, and contracts awarded for both residential and non-residential building had failed to record any growth since the turn of the year. As shown by the recent survey the Minneapolis Reserve Bank conducted for the Board, that was in part attributable to the somewhat greater selectivity of most major lenders in issuing commitments. But interest rates had also played a role. They had continued to edge higher and had now reached the point where the 8 per cent usury ceiling in Minnesota, a ceiling which was not changed in the legislative session just completed, was threatening to divert funds away from residential building.

The leveling in construction activity, Mr. Galusha continued, had not been accompanied by any easing in the upward push of costs and prices. Furthermore, the recent batch of settlements in the building trades in the Twin Cities indicated that construction costs would move up steeply in the next few years. The settlements called for wage and fringe benefit increases of from $2.60 to $2.85 per hour, spread evenly over the next three years. And local builders estimated that those labor cost advances would raise the price of an average house about $1,500, or 5 per cent, per year. He mentioned those settlements in the Ninth District because he believed they clearly indicated what could be expected in building trades' agreements in other areas. It was also sobering to realize that wage costs in construction would still be rising at a substantial rate two years from now.

Turning to the national level, Mr. Galusha remarked that the April slowdown in employment, income, and production was reassuring, but not yet convincing that the economy's real growth had declined significantly from the first-quarter pace. The forecast in the green book for the second and later quarters was quite reasonable, but he had now grown somewhat skeptical of the reasonableness of consumers; they could again reduce their saving rate by a sizable margin.

As to policy, Mr. Galusha saw no alternative to the Committee's present course. In following that course over the next period he would prefer to have the Manager hit the high side of the member bank borrowing range specified in the blue book; keep the Federal funds rate at 8-1/2 per cent or above; and activate the proviso clause vigorously if the credit proxy, adjusted for Euro-dollars and new credit devices, should appear to grow at an annual rate of 5 per cent or better. In following that specification he would hope that bank credit in June could be kept from developing an unwanted bulge, for any bulge that did appear was likely to remain as a permanent addition. Further, in order to keep bill rates up he would favor having the Manager supply reserves through coupon purchases and reduce reserves through bill sales.

Mr. Galusha thought that such a course might produce what could be defined as a crunch. However, he was less concerned than he was a while ago that that would be all bad, especially if the outcome could be confined to an instilled fear of a crunch. The extraordinary inventiveness of American business had been given more latitude than might have been desirable, at least in retrospect. Bankers might have behaved badly from the Committee's point of view, but that innovative responsiveness should always be predictable.

In concluding, Mr. Galusha remarked that monetary policy appeared to be accomplishing what it had set out to do, at a rate not materially slower than might have been expected. However, the possibility should be accepted that the legacy of gradualism might include an enforced reexamination of System use of some of the instruments of monetary policy--especially Regulation Q. He was particularly impressed with Mr. Hayes' comments on that subject this morning. He had no strong feeling about the language of the directive.

Mr. Swan observed that economic activity in the Twelfth District seemed to be advancing at a somewhat faster pace than in the nation as a whole. As he had indicated at the previous meeting, that pattern had developed in March; and it appeared from data on employment, housing starts, and business loans that it had continued in April. The unemployment rate for the Pacific Coast States dropped by 0.3 of a percentage point to 4.1 per cent in April, with the largest gains in employment relative to those in the nation occurring in construction and trade. However, employment in the aerospace industries continued to decline, and further declines were in prospect.

Mr. Swan noted that the increase in District housing starts in April was smaller than in March, but it brought starts to the highest level since February 1964. As of mid-May, lumber and plywood prices reflected some weakness in demand. On the other hand, higher agricultural prices, particularly for potatoes and other vegetables, had contributed to a substantial increase in March in cash receipts of District farmers.

District banks continued under considerable pressure, Mr. Swan said. Thus far in May, however, they had been able to maintain a high level of borrowings under repurchase agreements with corporations and public bodies, including the State of California.

With respect to the national economy, Mr. Swan remarked that the pace of the advance continued to moderate, although perhaps only slightly. When one related the continuing moderation in the advance to monetary policy, it appeared that policy had been on the right course thus far in 1969, despite the disturbing month-to-month fluctuations. He thought the Committee should maintain its present posture at this point. It would be necessary to rely on the Manager's judgment to a considerable degree in view of the uncertainties attaching to the various indicators and the possibility that they would follow conflicting courses in the month ahead.

Mr. Swan said he favored the draft directive in the form submitted by the staff. He agreed that it would be desirable to avoid any indication of relaxation, but he did not think an instruction to maintain "the prevailing firm conditions" would invite slippage. An instruction to maintain "continuing pressure on money and short-term credit markets," as suggested by Mr. Hayes, would seem to suffer from the lack of the kind of specific reference point offered by the word "prevailing" in the language proposed by the staff.

Mr. Coldwell said that over-all economic conditions in the Eleventh District remained at a high level with strong forces of stimulus or weakness not especially evident. One exception was the production of crude oil, which was at record levels. Economic indicators generally showed small pluses or minuses, although they were still tilted on the upside.

District banking developments in the past few week tracked the national trends, Mr. Coldwell continued, except for a minor increase in large-denomination CD's. In his recent contacts with District banking leaders, he found them worrying about heavy restraint, excess borrowing, and their large overhang of unused lines of credit--although they evidently were not worried enough to stop making loans. Unused credit lines were a matter of special concern since draw-downs had been quite scarce during the present period of restraint in contrast to the 1966 period. A few District bankers were becoming quite restive about the recurring restraint on their banks and the lack of restraint elsewhere. Bankers also told him that large business loans would be made routinely until all funds were exhausted or the Federal Reserve made a direct request to limit them.

Nationally, in Mr. Coldwell's opinion, there was some evidence of a slower rate of growth in the economy. On the other hand, there was substantial evidence that wages, costs, and prices were still advancing at a very rapid pace. He questioned whether businessmen could be expected to change the basis on which they were making decisions, given the rate at which costs were rising.

Mr. Coldwell remarked that the policy issues facing the Committee today could be summarized in terms of four questions: 1. Accepting the gradual approach, would another step in the direction of restraint cause an overkill? 2. Was the Committee willing to accept the projected rate of growth and the current rate of inflation for the remainder of 1969? 3. Could the Committee accept the uneven impact of monetary restraint among sectors of the economy and among units in the financial industry? 4. Was the current degree of restraint adequate to assure an acceptable rate of correction to the inflation or to the imbalances and distortions developing in the economy?

His answer to all those questions, Mr. Coldwell said, was basically no. In his opinion the Committee should press for further restraint through open market operations. Thus, he would prefer a directive with a second paragraph calling for slightly firmer conditions. Perhaps that could be achieved by merely shading decisions toward restraint, but he felt the attitude was of importance because it recognized an inadequate rate of correction of both the pace of inflation and the growing imbalances in the economy.

To add a footnote, Mr. Coldwell continued, he would mention that a number of Eleventh District banks were getting themselves so far extended because they refused to accept the idea that the Federal Reserve was going to maintain its current degree of restraint. They were continuing their loan efforts and some were getting lendable funds and sustaining their level of lending only by heavy borrowings from a variety of sources.

Mr. Latham remarked that, as set forth in the green book, there was some evidence of continued moderation in economic expansion. It was to be hoped that that was a real indication that fiscal and monetary policy were beginning to show results. To him, however, the real evidence that monetary policy was becoming effective was in the attitudes and comments of bankers. He sensed a change in the past month. A number of bankers were saying the "crunch" was here. They expressed concern for the strong inflationary psychology in the economy and verbally evidenced a growing awareness of the need to curtail many of the larger credits. At the same time, however, they gave no evidence--verbally or otherwise--that they could or would do so regardless of the purpose of the credit.

Bankers admitted that they were expending every effort to develop new sources of funds to meet loan demand, Mr. Latham continued. In the First District reluctance to use the discount window was fast fading. Discounts were repeatedly hitting new all-time highs. Some bankers were talking about further portfolio liquidations. In that environment, and until there was evidence of a reversal of the existing psychology, a continuance of the present firm monetary policy was in order.

Mr. Robertson made the following statement:

> At a time like this, monetary policy ought to be as restrictive as it can practically be. With the economy still in the grip of powerful inflationary forces--and with every price and balance of payments statistic underlining the harm those forces are doing--we must be prepared to wage a firm and determined campaign of restraint. And this means to me being willing to run greater risks of "over-kill" and recession--with confidence that we can avoid both--in the interests of the longer-run health of our system.
>
> I am aware that signs of monetary tightness are showing up, and that here and in the real economy we can see somewhat slower rates of advance. But we should be very careful not to take comfort from those few signs. We have learned, I hope, from bitter experience how stubborn inflationary attitudes can be and how quickly they can break out anew if we relax our guard for a moment. All the evidence suggests to me that a gradualistic approach to the inflationary problem runs a serious risk of its own, for it gives support to the very doubts and skepticisms that are compounding our difficulties; it is, no doubt, partly the reason for the existing credibility gap between the public and Government. Today's inflation is based in large part on public psychological attitudes. Hence, the more quickly we can--by our actions--convince businessmen and bankers that our course is set, the faster and more successful we are likely to be in reversing the trend and reestablishing a sustainable rate of economic growth with reasonable price stability. Consequently, we should be searching for practical ways to speed up the cooling-off process.

In speaking of ways to make our policy more effective, I want to emphasize that I am not attracted to actions that simply push interest rates higher. Particularly in times like these, when borrowers and lenders alike expect future dollars to be worth less and less, the price of money by itself is hardly a deterrent. Availability of credit is the key, in my opinion, and I think we ought to be focusing our attention on steps that can curtail the availability of funds rather than increase their cost. This means that I can see little help forthcoming from higher day-to-day money rates per se, or even from a higher discount rate or prime rate. I would like to see open market operations keep reserve conditions very taut, but it may well be that the most effective further measures open to us are not Trading Desk operations but rather some regulatory steps to insure that bank efforts to raise funds through nondeposit routes do not frustrate our endeavors to compel a real tightening of bank lending policies. For it is through the curtailment of bank lending, and the damper that will put on the spending decisions of would-be borrowers, that we can have some hope of expediting the cooling-off process and moving in more timely fashion back to a path of sustainable economic advance.

With these views I would be willing to support the draft directive to the Manager, but on the assumption that he would be quick to cut off any trace of developing reserve ease, even for a few days, and that he would move promptly and forcefully to clamp down still harder on reserve availability if there were signs of any greater-than-expected increase in the monetary aggregates, including not only direct bank credit but also the volume of credit that banks may try to divert through the nondeposit financing channels under their control. To do any less, I fear, would be to risk losing the sense of firm and inescapable restraint that I regard as the essence of responsible central banking in this hour.

Chairman Martin said he thought the present was a critical period. As he had noted on other occasions recently, he was disturbed by indications that both businessmen and bankers now appeared to think that it was the Government's job to deal with the problem of inflation and that they themselves had little or no responsibility in that connection. The same seemed to be true with respect to the balance of payments; the modest relaxation that had been made in the Commerce Department and Federal Reserve programs were being interpreted as implying that the field was wide open and that except for the Government no one need be concerned with the payments problem.

He was also disturbed, the Chairman remarked by the continuing skepticism regarding the determination of policy makers to cope with inflation. It was widely assumed that the Federal Reserve was prepared to bail out those who might find themselves in financial difficulty if they complained loudly enough; and that a 1/2 point increase in the unemployment rate would result in an abandonment of fiscal restraints and a large increase in Federal spending.

He hoped no member of the Committee would underestimate the seriousness of the situation, Chairman Martin continued. In view of existing problems, including the balance of payments problem, and the prevailing attitudes in the business and financial communities, he thought the only responsible course for the Federal Reserve was to maintain the prevailing pressure. No member of the Committee wanted a crunch, and none wanted a recession; everyone wanted to put the economy on a stable basis by disinflating without deflating. He was not aware of any recent developments that called for an overt change in the Committee's policy. He might have favored moving toward a slightly more restrictive posture today, in the manner suggested by one or two members of the Committee, were it not for the fact that heavy pressures in financial markets were expected around the June tax date. After that period of pressure was past the Committee might well want to consider adopting a slightly more restrictive posture, depending on the circumstances prevailing then.

Chairman Martin said he would find the staff's draft directive acceptable on the understanding that there would be no diminution of pressure. The modifications that had been suggested in the staff's draft did not strike him as significant, although he would not necessarily object to some changes along the lines proposed. In that connection, he noted that Mr. Holland had given him an alternative proposal for the first sentence, reading "...expansion in real economic activity is gradually moderating...."

Mr. Brimmer remarked that he personally would prefer to avoid the use of the word "gradually," and Mr. Mitchell agreed.

Mr. Robertson said he had no objection to the first sentence of the staff's draft. However, if the Committee wanted to take account of the reasoning underlying Mr. Hayes' proposal it might rewrite the statement to say that "...expansion in real economic activity is continuing to moderate slightly...."

Mr. Hayes said that language would be acceptable to him.

Mr. Daane expressed a similar view. He added that he thought it would be desirable to revise the second paragraph along the lines Mr. Hayes had suggested, to convey better the sense of persistent pressure.

Mr. Mitchell remarked that he had been impressed with Mr. Swan's comment that such language lacked a specific reference point.

Mr. Maisel commented that, as he understood the matter, there was no decision to increase pressure on the market. If there were additional pressures from market sources the Manager would accordingly relax his own efforts to maintain pressure.

Mr. Hayes observed that Mr. Swan's point might be met by calling for operations to maintain "the prevailing pressure on money and short-term credit markets."

Chairman Martin then suggested that the Committee vote on a directive consisting of the staff's draft with the modification in the opening sentence proposed by Mr. Robertson and with the second paragraph revised in the manner Mr. Hayes had just suggested.

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

The information reviewed at this meeting suggests that expansion in real economic activity is continuing to moderate slightly, but that substantial upward pressures on prices and costs are persisting. Interest rates have risen in recent weeks. Bank credit and the money supply appear to be changing little on average in May after bulging in April. The outstanding volume of large-denomination CD's has continued to decline, and the available evidence suggests only modest recovery in other time and savings deposits at banks and in savings balances at nonbank thrift institutions following the outflows of the first half of April. The U.S. balance of payments on the liquidity basis was in sizable deficit in the first 4 months of 1969 but the balance on the official settlements basis remained in surplus as a result of large inflows of Euro-dollars. However, there were substantial outflows of funds from the United States in the first half of May, during the period of intense speculation on a revaluation of the German mark, and the payments balance was in very large deficit on both bases. 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 a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the prevailing pressure on money and short-term credit markets; provided, however, that operations shall be modified if bank credit appears to be deviating significantly from current projections.

Chairman Martin then suggested that the Committee continue the discussion it had begun at the previous meeting on the subject of possible outright System transactions in Federal agency issues. He noted that a memorandum from Mr. Robertson, entitled "Proposed experimental transactions in Federal agency issues," and dated

May 5, 1969[1] had been distributed to the Committee. The Chairman invited Mr. Robertson to open the discussion.

Mr. Robertson said his memorandum pointed up the problem facing the Federal Reserve and suggested that outright operations in agency issues should be authorized on an experimental basis. In his judgment the System would be in a very difficult position if it did not take action to utilize a statutory authority it had requested in 1966. If the Committee agreed, he thought the proper approach would be to amend the continuing authority directive to authorize the Desk to buy and sell agency issues on an outright basis, on the understanding that it would not actually engage in such operations until the matter had been explored thoroughly with the Treasury. The Chairman and he had had some discussions of the matter with Treasury officials but he thought they should be consulted again to get the advantage of any additional views they had. Perhaps after those discussions the Committee would decide not to initiate such transactions at this time, but it would nevertheless be useful for the Desk's authority to be in place. If the Committee intended to authorize outright transactions, he thought it should do so as quickly as possible. In his judgment, operations should be authorized on a relatively limited scale;

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

in his memorandum he had proposed a $200 million limit on changes in System holdings of agency issues between meetings of the Committee.

In concluding, Mr. Robertson said that if there were any misstatements of fact in his memorandum he would appreciate having them pointed out. Of course, there was always the possibility of differences of interpretation.

Chairman Martin concurred in Mr. Robertson's view that further discussions should be held with the Treasury. He had checked with Secretary Kennedy and Under Secretary Volcker this morning and thought it was fair to say that there was no pressure from them at the moment for the System to undertake outright operations in agency issues. They were considering the matter further and had not yet arrived at a firm position.

Mr. Daane said he thought it would be desirable to wait for a clarification of the Treasury's position, particularly since they had the matter under review at present. On the substantive issue, his judgments differed from those Mr. Robertson had expressed in his memorandum on two main counts. The first related to Mr. Robertson's conclusion that a decision to engage in experimental operations would be reversible if the market response were troublesome. His own feeling was that such a decision was not likely to be easily reversible, once the

Committee had implied acceptance of the principle that it would be advantageous to conduct outright operations in agencies. Mr. Robertson had indicated in his memorandum that the System had found it possible to reverse certain decisions in the past, but he (Mr. Daane) would note that such reversals had not always been made without a great deal of difficulty.

Secondly, Mr. Daane continued, he thought the memorandum went a bit far in saying that there were no conclusions in the Steering Committee's report on the Government securities market study that argued against experimental operations now. In his judgment experimental operations would be subject to all of the problems noted in the Steering Committee's report--such as those posed by the typically small size of individual agency issues and the consequent risks of unduly influencing prices, that of choosing particular issues for purchase, and so forth. Indeed, some such problems were likely to arise with even greater force in a limited trial than in full-scale operations; for example, there would be an increased need to be selective among the various issues available for acquisition.

Mr. Hayes remarked that he fully supported Mr. Daane's views. The Treasury certainly had an active interest in the matter, he saw no reason for the System to authorize outright operations in agencies before Treasury officials had developed a firm position. The Steering Committee had given a good deal of thought to the subject, and its conclusion was that there were more risks than advantages in outright operations. He had not seen any convincing evidence to suggest that the Committee should reach a contrary conclusion. He agreed with Mr. Daane that the problems noted in the report would apply to experimental operations as well as to operations on a larger scale, and he was impressed with the risk that once the System undertook outright operations it would find it very difficult and perhaps embarrassing to discontinue them. In his memorandum Mr. Robertson had noted that the System had used the experimental approach with apparent success in beginning again to buy Treasury coupon issues. In his (Mr. Hayes') judgment, the analogy was faulty in an important respect; unlike the markets for individual agency issues, the market for Treasury coupon issues did not have a constituency. He was concerned about the pressures to which the System was likely to be subject if it undertook outright operations in agencies.

Finally, Mr. Hayes said, the present seemed to him to be a particularly undesirable time to undertake such operations, even on an exploratory basis, because of the current tendency toward proliferation of small issues. The Steering Committee had suggested that the operational problems would be reduced if there were some consolidation into a smaller number of large issues, but the present trend seemed to be in the opposite direction.

Mr. Bopp commented the Committee had to consider the possibility that if the System did not utilize its statutory authority to engage in outright operations, Congress might enact legislation making System purchases of agencies mandatory and perhaps specifying objectives to be achieved. It seemed to him that dealing in agency issues was not at all necessary to achieve the major goal of monetary policy--that of appropriately influencing aggregate demand--and might actually complicate achievement of that goal. And no doubt there would be technical difficulties, as suggested in the Steering Committee's report. Nevertheless, when one looked into the Congressional history on the matter, he found that some members of Congress had radically changed their views between 1966 and 1968. For example, in 1966 Senator Proxmire had been reluctant to provide such authority "unless it is going to be used, unless there is real need for it, and unless...it is likely to be an instrument that will have a good effect." But two years later he introduced legislation that would have made System dealings in agencies mandatory. Some day Congress as a whole might instruct the System to undertake operations in agency issues.

On balance, Mr. Bopp said, he was inclined to go along with Mr. Robertson's suggestion. He recognized the hazards, but he thought that the System would be able to withstand outside pressures if the issue were clear-cut. He noted that it had done so in the past--for example, on the issue of pegging Government security prices.

Mr. Mitchell said that as he recalled the discussions of the Steering Committee the concern expressed about the problems of System operations in agency issues was not particularly strong, and the Steering Committee could as easily have come down on one side of the question as on the other. It seemed to him that the appropriate step at this juncture was not to amend the continuing authority directive but to ask the Manager to draft a set of guidelines for operations in agencies that would minimize technical problems. After the Committee had a draft of such guidelines and had received an indication of the Treasury's views, it would be in the position to authorize experimental operations if it so chose.

Mr. Hayes referred to Mr. Bopp's comments about congressional attitudes and remarked that the System obviously would undertake operations in agencies if Congress issued an instruction to that effect. However, Congress had not told the System to operate in agencies; it had simply authorized such operations. It seemed to him that in so doing Congress was relying on the System to use its best judgment, as it did in connection with monetary policy questions in general. On that basis, the System was free not to engage in outright transactions in agency issues if it thought the hazards outweighed the prospective gains.

Mr. Brimmer said he hoped the Committee would not reach its decision simply on the basis of whether or not it thought Congress had expected it to use the authority granted in 1966. It was important to recall that on the amendment offered by Senator Proxmire in 1968--which would have made it mandatory for the System to buy obligations directly from the Federal agencies concerned with housing--the vote in the Senate was 45 to 46. The closeness of the vote came as a surprise to many observers. Behind that vote was a conviction on the part of many Senators that there should be new special facilities for housing finance. Others favored special facilities for export paper. In his judgment, the real hazard was not that Congress would give the System a directive to buy agency issues in general, but that it would specify a laundry list of particular issues to be supported. He thought there was more danger of that outcome than might appear on the surface because of the discontent with the impact of monetary restraint on particular sectors of the economy.

Mr. Brimmer observed that he would support the proposal for experimental operations in agency issues generally, not simply in those related to housing or to exports and not necessarily within the dollar amount Mr. Robertson had suggested. He thought the Committee should not overlook the point Mr. Robertson had made in his memorandum that supplying reserves through purchases of Treasury bills at times like the present, when the market supply of bills was relatively limited, could produce undesirable downward pressures on bill rates. More generally, unless the Committee broadened the range of instruments in which it operated it was likely to run into difficulties in the future conduct of open market operations. He had no objection to Mr. Mitchell's suggestion that the Manager be asked to draft guidelines for operations in agencies. However, he would not want to ask Mr. Holmes to make a new, one-man study of the underlying issues; rather, the draft guidelines should be formulated as if they were to implement a favorable decision by the Committee.

Mr. Maisel said he agreed with Mr. Brimmer about the risks of congressional directive to the System. It was his recollection that there were no dissents by members of the Joint Economic Committee from either the majority or the minority to that part of the Committee's 1969 report which called on the Federal Reserve to undertake outright operations in FNMA and FHLB issues to assist housing.

Mr. Cardon confirmed Mr. Maisel's impression. He added that yesterday the Commission on Mortgage Credit, the membership of which included some Senators and Representatives on the Joint

Economic Committee, had tentatively agreed to criticize the System for not having used the authority to operate in agency issues to a greater extent than it had. Their objective was to improve the markets for those securities. The Commission did reject Mr. Patman's suggestion that a goal for such purchases be set in terms of a particular level of housing starts.

Chairman Martin commented that the views of the Joint Economic Committee were not necessarily those of Congress as a whole.

Mr. Maisel agreed, but added that the Joint Economic Committee did include most of the ranking majority and minority members of both the House and Senate Banking and Currency Committees.

Mr. Sherrill observed that his present inclination was to authorize experimental operations in agency issues. Before reaching a final conclusion, however, he would like to know the Treasury's position.

Chairman Martin expressed the view that the Committee should have a clear-cut understanding of the Treasury's position before it acted. Personally, as one with some experience in financial markets, he thought it was unlikely that operations in agency issues would benefit System policy or would improve the markets for such securities; the more likely outcome was that the System would simply find itself holding a certain volume of agencies in its portfolio. He had discussed the subject with a number of participants in financial markets on a visit to New York last week, and found that they were almost unanimously of that view. They also thought that the present was a particularly poor time to undertake such operations.

However, the Chairman continued, although he doubted that agency operations would be useful to the System or the market, he could not prove the point. He was not sure that limited experimental operations would commit the System to move on to larger-scale transactions, and he thought a case could be made for experimenting in a modest way. At the same time, he did not know whether or not experimental operations would put the System in a better position with respect to the future.

In his judgment, the Chairman said, much of the congressional support for System operations in agencies reflected a desire to direct more funds to the housing sector rather than any particular interest in the markets for such issues. He personally would prefer to have funds appropriated directly for housing, but it might well be that the System would have to participate through its open market operations. He was saddened by the fact that the System was involved in a political matter whether it liked it or not. Although the Federal Reserve had done its best to remain removed from politics, there was no question but that the present issue had political overtones.

Mr. Hayes commented that the System had worked valiantly over the years to combat that idea that it was appropriate for a central bank to undertake to assist specific sectors of the economy. While he agreed that experimental operations in agencies would not necessarily open the door to such an undertaking, he was not persuaded that the action proposed today would enable the System to avoid facing up to the basic issue in the period ahead. Apparently the System had not done an effective job in convincing Congress that the proper concern of the Federal Reserve should always be with over-all monetary and credit conditions rather than with conditions in individual sectors.

Mr. Mitchell remarked that the System had departed from that rule in a least one respect, by undertaking to cultivate the market for bankers' acceptances.

Mr. Daane said he wanted to underscore the point that this was a very poor time for beginning operations in agencies. He expected the Treasury to reach the same conclusion. The Administration presently was looking for ways to achieve some kind of centralized control of issues by the various agencies, or at least some coordination of those issues and its own direct borrowing. In his judgment, a System decision to start buying agency issues at this time would damage those efforts at control and coordination.

Mr. Robertson commented that the contrary might be the case; by pointing up the problems in the agency market, experimental operations by the System might prove helpful to the Treasury.

Chairman Martin said he thought the suggestion that Mr. Holmes be asked to draft guidelines was a good one. It was clear from the discussion today that there were arguments on both sides of the question as to whether the System's position would be improved by undertaking experimental operations. As Mr. Hayes had implied, the Federal Reserve had to try to do a more effective job of convincing Congress that there were appropriate and inappropriate objectives for a central bank.

Mr. Hayes said he would have no objection to asking the Manager to draft guidelines for experimental operations in agency issues so long as it was understood that the request did not prejudice the question of whether such operations should be undertaken.

Mr. Mitchell expressed the view that the guidelines should be developed on the assumption that the Committee was seriously considering going ahead with operations but wanted the minimum exposure to risk.

Mr. Galusha commented that as he understood the matter the Committee wanted both the guidelines and a firmer indication of the Treasury's views so that it would be in a better position to vote on the proposal than it was today.

The Chairman agreed with Mr. Galusha's comment.

Mr. Brimmer remarked that it probably would be helpful for Mr. Holmes to proceed on the assumption that the Committee's decision was likely to be favorable. Relatively soon--perhaps as early as July--the System probably would be testifying before Congress on the extension of legislation that included the authority for it to operate in agency issues. If, as he assumed, the System would be recommending extension of that legislation the sooner outright operations were undertaken the better it would be.

Chairman Martin said he thought Mr. Brimmer had made a good point. If the Committee's decision were negative it presumably would have to be defended at the hearings on the basis that this was an inappropriate time to begin outright operations in agency issues.

Mr. Daane suggested that the Manager be asked to proceed on a wholly objective basis, taking careful account of the potential problems.

Mr. Hayes commented that in light of the sharp division of views within the Committee it did not seem reasonable to ask the Manager to proceed on the assumption that the decision would be favorable.

Mr. Maisel remarked that his understanding differed from that of Mr. Hayes. As he understood it, the Manager would be asked to prepare a set of guidelines that would aim at maximizing the feasibility of the operations in question. If the Committee then decided that such operations were still not feasible, presumably it would make a negative decision on the matter.

In response to a question, Mr. Holmes said he would not anticipate any particular problem in connection with his approach to the assignment. When one drafted guidelines for particular operations it was necessary to set aside the problem of whether or not the operations themselves were desirable. Some preliminary thinking on the subject had in fact already been done at the trading desk.

Mr. Robertson referred to the Chairman's comment that the defense of a negative Committee decision would have to rest on the matter of timing. He suggested that it would be helpful in that connection if the Manager would also prepare a list of the considerations that argued against proceeding with outright operations in agency issues at this time.

The Chairman agreed that such a list would be desirable.

It was agreed that the next meeting of the Committee would be held on Tuesday, June 24, 1969, at 9:30 a.m. Chairman Martin noted that current plans called for a chart presentation by the staff at the meeting.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

May 26, 1969

Draft of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on May 27, 1969

The information reviewed at this meeting suggests that expansion in real economic activity is continuing to moderate, but that substantial upward pressures on prices and costs are persisting. Interest rates have risen in recent weeks. Bank credit and the money supply appear to be changing little on average in May after bulging in April. The outstanding volume of large-denomination CD's has continued to decline, and the available evidence suggests only modest recovery in other time and savings deposits at banks and in savings balances at nonbank thrift institutions following the outflows of the first half of April. The U.S. balance of payments on the liquidity basis was in sizable deficit in the first 4 months of 1969 but the balance on the official settlements basis remained in surplus as a result of large inflows of Euro-dollars. However, there were substantial outflows of funds from the United States in the first half of May, during the period of intense speculation on a revaluation of the German mark, and the payments balance was in very large deficit on both bases. 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 a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

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