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, July 15, 1969, at 9:30 a.m.

PRESENT: Mr. Martin, Chairman
Mr. Bopp
Mr. Brimmer
Mr. Clay
Mr. Coldwell
Mr. Daane
Mr. Maisel
Mr. Robertson
Mr. Scanlon
Mr. Sherrill
Mr. Treiber, Alternate for Mr. Hayes

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

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

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

Mr. Cardon, Assistant to the Board of Governors
Mr. Coyne, Special Assistant 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. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Mr. Baker, Economist, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

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

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on June 24, 1969, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on June 24, 1969, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on

Open Market Account and Treasury operations in foreign currencies for the period June 24 through July 9, 1969, and a supplemental report covering the period July 10 through 14, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that since the last meeting of the Committee the gold and foreign exchange markets had been relatively quiet; the Treasury gold stock had remained unchanged; and the gold holdings of the Stabilization Fund had remained steady at slightly under $800 million. The Zurich gold price had fluctuated between $41 and $42, with indications that 50 to 60 per cent of South African gold production was now flowing onto the market.

On the exchange markets, Mr. Coombs continued, the pull of Euro-dollar rates and covering of short positions taken during the May crisis had been the dominant factors and had tended to obscure more basic trends in the flow of trade. In effect, the market was rocking along on the assumption that no parity changes or other major developments would occur until after the German elections, which were scheduled for September 28, just on the eve of the annual meetings of the International Monetary Fund and World Bank. At the same time, market operators were poised to undertake immediately massive hedging and speculative operations if anything occurred to disrupt the timetable they now had in mind. Most European central bankers were hopeful of getting through the rest of this month as well as August without serious trouble, but all of them were gravely apprehensive of what September would bring. The international financial system was confronted with a truly explosive situation, largely attributable to the political logjam on parity realignments.

In the case of France, Mr. Coombs said, the appointment of a new Government had brought about a temporary lifting of spirits and relief from pressure on the French franc. However, over the past ten days there had been further reserve losses of more than $100 million and such losses would probably continue. Since May 1968 the Bank of France had lost $3-1/4 billion of gold and foreign exchange, including the cashing in at the Fund of a super gold tranche position and a position under the General Arrangements to Borrow, with the two together totaling $640 million. Over the same period the French authorities had fully drawn their $245 million gold tranche from the Fund and had borrowed $1.5 billion net from foreign central banks and the U.S. Treasury; only $80 million now remained available to them under the Bonn credit package. All told, therefore, the French had lost $5 billion since May 1968. There had been no slackening in the outflow; in the last three months they had lost well over $1 billion.

As the Committee knew, Mr. Coombs continued, some of the earlier French drawings on the Bonn credit package had served to pay off maturing debt under the Federal Reserve swap line. The line was fully cleared last May, and the entire $1 billion currently remained on a standby basis. The Bank of France was now trying to secure renewals of the six-month credit lines provided by other central banks under the Bonn package, and the U.S. Treasury had agreed to help that effort by renewing the Treasury line. He was hopeful that the Bank of France would be able to roll over its drawings on others as they matured so that the maturities would not be occasions for further French reserve drains. More generally, however, the basic deficit in the French balance of payments seemed likely to continue; Bank of France officials were estimating that the trade deficit alone might run between $1 billion and $1-1/2 billion during the second half of this year, leaving out of account the effects on capital flows of possible speculative pressures. It seemed reasonably likely, therefore, that the Bank of France would again be forced to draw on the swap line with the Federal Reserve during the coming weeks, and that large-scale drawings would become necessary by September. He was not sure how one should define a condition of fundamental disequilibrium for a country like France, but when such a country lost $5 billion in a little more than a year, it seemed clear that something was basically wrong. He would expect the French situation to go steadily downhill until some basic corrective measures were taken--hopefully, in the context of a revaluation of the mark.

In the case of the United Kingdom, Mr. Coombs said, the pound was currently benefiting not only from short covering of speculative positions taken last May, but also from the very tight squeeze currently being exerted by both fiscal and monetary policy. For the first time in a long while sterling was actually short in the market, and short covering tended to run up the rate and to bring in dollars. The good trade figures for May had helped to bring about some recovery of confidence which was reinforced, he thought, by the publicity given to the discipline now being exerted on British financial policy by the International Monetary Fund. Incidentally, the letter of commitment secured by the Fund from the British represented a major new development in international finance.

As the Bank of England had continued to take in money, Mr. Coombs observed, he had tried to encourage them to give priority to paying down their swap debt to the System rather than repaying other creditors or adding to reserves. As the Committee knew, a repayment of $115 million had been made at the end of June. That was the only central bank credit repayment made by the Bank of England in June. Another $100 million had been paid off yesterday and $60 million more would be repaid tomorrow, reducing the British debt under the swap line to $865 million. There was some possibility of further paydowns during the rest of July. Large oil royalty payments would be made to Kuwait and if the latter took advantage of the dollar exchange guarantee the British were prepared to offer, the Bank of England would take in more money which, he trusted, they would use to make repayments on the swap line. He was hopeful that the Federal Reserve could continue to enjoy a priority over other creditors of the Bank of England until its percentage share of total short-term credits to the British was reduced substantially from its present level of close to 60 per cent to a figure well below 50 per cent.

Mr. Coombs concluded by noting that the British situation remained highly vulnerable, and that the Bank of England probably would again have to make large drawings on the Federal Reserve if there were a new crisis. However, they might be able to reduce their recourse to the System in such an event by calling on the German Federal Bank to conduct recycling operations.

By unanimous vote, the System open market transactions in foreign currencies during the period June 24 through July 14, 1969, were approved, ratified, and confirmed.

Mr. Coombs then reported that $70 million still outstanding on a drawing by the Federal Reserve on the Swiss National Bank would reach the end of its first three-month term on July 30, 1969. He expected that the amount outstanding would be reduced to $50 million tomorrow through a purchase of Swiss francs and a sale of dollars to the Swiss National Bank. The drawing in question had a somewhat unusual background. At the end of July 1968, at a time when the System's Swiss franc swap lines were entirely clear, the System had had to make a $75 million drawing on the Swiss National Bank. As a result of further drawings, outstandings had reached a peak of $320 million at one point, but later the balance was reduced. In any case, the swap line had remained in continuous use until the remaining balance of $40 million was cleared up on April 29, 1969, through the issuance of a Swiss franc note by the U.S. Treasury. The very next day, April 30, at the request of the Swiss National Bank, the System drew again in the amount of $100 million, and of that amount $50 million would still remain outstanding tomorrow. Technically speaking, he supposed, one could say that continuous use of the swap line since July 1968 had been interrupted by the repayment the Federal Reserve made on April 29, 1969. However, the time interval of one day before another drawing was made was so brief that he had thought it was realistic to consider the line as having been in continuous use since the end of July 1968. On that basis, if the drawing maturing on July 30 were renewed the line would have been in continuous use for more than a year.

Accordingly, Mr. Coombs said, he had approached the U.S. Treasury with a request to take over any residual debt that remained outstanding under that line as of July 30 through the issuance of a Swiss franc debt instrument, and they had agreed to do so. He thought the Swiss also would be agreeable to that procedure. He was, therefore, not asking the Committee to approve a renewal of the swap drawing falling due on July 30 on the assumption that he would be able to work out arrangements between the Swiss and the U.S. Treasury to clean up the line completely.

Mr. Coombs added that this was the first time such a situation had arisen. He was interested in knowing whether the Committee concurred in his view that permitting a swap line to remain in use under such circumstances would violate the spirit of the one-year rule even though technically there was no violation.

Mr. Sherrill asked how long Mr. Coombs thought a swap line should be clear before it would be reasonable to conclude that it had not been in continuous use.

Mr. Coombs replied that he would prefer to have the swap line clear for perhaps a month, although if a crisis arose an interval of a few weeks might be considered acceptable. In any case, he thought one day was certainly too short a period.

Mr. Daane asked whether the appropriate interval would not depend in part on the circumstances of the case and the urgency of the drawings involved.

Mr. Coombs replied that the Committee, of course, could always decide that exceptional circumstances warranted permitting a swap line to remain in continuous use for more than a year. What concerned him was whether it was necessary to raise such a question for Committee consideration in a case where a line would be in continuous use for more than a year except for a very brief interval.

Mr. Hickman observed that in the case under discussion the Swiss National Bank apparently had been holding what they considered to be an excessive amount of dollars on the very day the System had repaid its earlier drawings.

Mr. Coombs confirmed Mr. Hickman's statement. He added that that situation had arisen partly because he had been away from his office for an extended period in late winter as a result of injuries he had suffered in an automobile accident. He had begun negotiations looking toward clearing up the System's Swiss franc debt at the February Basle meeting, but the negotiations had remained in abeyance during his absence. In that period the Swiss National Bank had accumulated more dollars.

Chairman Martin and Messrs. Robertson and Daane said they concurred in Mr. Coombs' view of the matter at issue, and no member expressed a contrary judgment.

Mr. Coombs then reported that a $50 million drawing by the Austrian National Bank would reach the end of its first three-month term on August 21, 1969. He recommended that the drawing be renewed for another three-month period if the Austrians so requested.

Renewal for a further period of three months, if requested, of the drawing by the Austrian National Bank was noted without objection.

Mr. Coombs reported that a series of drawings by the National Bank of Belgium, totaling $99 million, would reach the end of their first three-month terms in the period from August 8 through August 15, 1969. Those drawings had been occasioned by the speculative crisis of May. However, the Belgian swap line had been in continuous use since September 30, 1968, and if the drawings now falling due were renewed for three months and remained outstanding for their full terms the line would have been in continuous use for more than a year. After discussing the matter with officials of the National Bank of Belgium he was happy to be able to report that he had their categorical assurance that, even if they should find it necessary to request renewal of the drawings when they matured in August, they would repay them in full before the end of September. He recommended renewal of the drawings maturing in August, if that should prove necessary, on the understanding that the whole swap line would be cleared up before the end of September.

By unanimous vote, renewal for further periods of three months, if requested, of the swap drawings by the National Bank of Belgium maturing in the period August 8-15, 1969, was authorized.

Mr. Coombs then said that certain sizable drawings by the Bank of England also would mature in August. Specifically, drawings of $225 million and $240 million would reach the end of their first three-month terms on August 11 and 12, respectively, and a drawing of $250 million would reach the end of its third three-month term on August 21. As he had mentioned earlier, there was some possibility that the British might be able to take in enough money this month to prepay part of that maturing debt, but he would strongly doubt that they would have the money to cover the bulk of it. Accordingly, he recommended renewal of the drawings at maturity, if so requested by the Bank of England. As the Committee knew, the British swap line had been in continuous use since July 1, 1968.

By unanimous vote, renewal for further periods of three months, if requested, of the swap drawings by the Bank of England maturing in the period August 11-21, 1969, was authorized.

Chairman Martin invited Mr. Daane to report on developments at the meeting of the Group of Ten Deputies in Paris and at the July Basle meeting.

Mr. Daane said the G-10 Deputies had met in Paris for a day and a half beginning on the afternoon of June 27. The discussion on the 27th had been concerned entirely with the question of possible increases in IMF quotas. Press reports indicating that the Europeans had insisted on an increase in quotas as a condition for activation of Special Drawing Rights were erroneous, but it was the consensus of the Europeans that for purposes of deciding on SDR activation it would be useful to have an approximate idea of the future size and pattern of Fund quotas. However, as the discussion proceeded it became clear that there were considerable differences among the Europeans as to whether quota increases should be selective, general, or both. The position taken by the U.S. representatives was that this country had no objection to consideration of quota increases but felt that such consideration should not take precedence over the decision on SDR activation and should not be permitted to delay that decision. Since the quota issue obviously was a complicated one that would take time to work out, the U.S. representatives proposed that discussion of the subject be held over until after the Bank-Fund meetings in September and then continue in 1970, the year in which the quinquennial consideration of quotas was due in any case; and that work go forward now on SDR's with a view to decision as to initial activation at the time of the Bank-Fund meetings in September.

On the following day, Mr. Daane continued, the Deputies considered the question of SDR activation. He had found the discussion useful and encouraging. The consensus was clearly for an activation decision at the time of the Bank-Fund meetings in September, and the amounts the Europeans had in mind were somewhat higher than had been anticipated. The range discussed at the meeting was from $2 billion a year to $4-1/2 billion a year. As to the period over which SDR's should initially be allocated, some countries advocated two or three years, and some, including the United States, Britain, and the Netherlands, advocated a full five years. The U.S. position was that activation in the amount of $4-1/2 billion for five years would be in accordance with the reserve objectives of the various countries concerned and would provide the flexibility necessary to permit the United States and Britain to achieve their balance of payments objectives and to permit Britain and France to make reasonable repayments. He was hopeful that SDR activation would go forward on schedule. The matter was scheduled to be considered further at a meeting of the Common Market Ministers on July 21-22, and at the next meeting of the G-10 Deputies, which would be held in Paris on July 23-24.

At the July Basle meeting, Mr. Daane remarked, the discussion focused on Euro-dollar market developments. The meeting was held on July 6, against the background of the recent heavy Euro-dollar borrowings by U.S. banks. Also, the report of the Meeting of Experts on the Euro-Currency Market, which had been held in Basle on June 9 and 10, had just been submitted. As the members knew, Mr. Solomon of the Board's staff and Mr. Klopstock of the New York Bank's staff had attended the Experts' meeting in early June. That meeting had reviewed the effects of high Euro-dollar rates on the various countries and had been given an explanation of the problems for the United States in attempting to modify the effects of its tight monetary conditions on other countries. He (Mr. Daane) thought it was fair to describe the Experts' report as inconclusive; it made no general recommendations to the Governors, but simply said that each central bank had to deal with problems posed by Euro-dollar developments as it saw fit. The consensus among the Governors at Basle, as formulated by Dr. Zijlstra, was that they welcomed the U.S. measures to combat inflation but felt that those measures were having disproportionate effects on their own economies and policies. There appeared to be greater concern than earlier with the effects of the pull-back of Euro-dollars to the United States, although to some extent views remained mixed, with some countries welcoming the high Euro-dollar rates as supportive of their domestic policies. The most vocal criticism came from the Belgians, who accused the United States of not displaying the proper spirit of international cooperation.

In summing up Dr. Zijlstra noted that there were three possible approaches to the Euro-dollar problem, Mr. Daane continued. The first was for the Federal Reserve to try to deal with the problem by using the reserve requirement instrument. The group felt that the recent Board proposal for a 10 per cent marginal reserve requirement on Euro-dollar borrowings was not likely to have much effect except to raise interest rates in the Euro-dollar market. Some felt it could be made effective by setting a very high requirement--figures in the range of 20 to 50 per cent were mentioned, and the Belgians suggested 100 per cent. However, others, including the Swiss, French, and Italians, felt that a high requirement would simply accentuate the upward pressure on interest rates domestically and internationally. Moreover, there was no evidence of support in the Basle group for the proposed automatic reduction of the reserve-free base as Euro-dollar borrowings were reduced. Although they did not fully understand it, they did not like the idea of "locking in" such funds, even in part, and suggested that the Board might critically re-examine that feature of the proposal.

Mr. Daane went on to say that the second possible approach noted by Dr. Zijlstra in his summation was for the Board to raise Regulation Q ceilings. There had been an extended discussion during the meeting of the rationale of the Board's policy of maintaining the existing ceilings. On the whole, the Europeans felt that an increase in or elimination of the ceilings would be the best solution to the Euro-dollar problem. The third approach mentioned involved greater use of moral suasion by the U.S. monetary authorities. Dr. Zijlstra himself was most vocal in urging that more could be done in that area.

Contrary to press reports, Mr. Daane observed, there was no discussion of the South African gold situation at the Basle meeting. At the Governors' dinner that evening, which he had attended along with Mr. Coombs, there was a long, diffuse, and rather unproductive discussion sparked by certain questions Dr. Zijlstra raised. The questions were whether the world was on a dollar standard; if so, what the implications were; and if not, how a dollar standard could be avoided. He would not attempt to summarize that discussion, except to note that it revealed the Europeans' unhappiness with the notion of a dollar standard. Perhaps Mr. Coombs had some further observations to offer.

Mr. Coombs said he agreed with Mr. Daane that the discussion at dinner was generally unproductive. The only point he would add was that there was no evidence of support for Governor Carli's recent suggestion regarding greater exchange rate flexibility.

Chairman Martin then invited Mr. Brimmer to report on the recent Paris meeting of the Economic Policy Committee he had attended and on his subsequent visits to Rome and London.

Mr. Brimmer said the EPC meeting, which was held on June 30 and July 1, was the first employing the new format involving a general discussion of key issues rather than a country-by-country review. On the whole, he thought the group's performance had been hopeful. The main thrust of the discussion was on inflation in the OECD countries and how it might best be dealt with. The OECD Secretariat offered an interesting new concept involving "centers of infection," and went on to suggest that the United States was the principal source of infection and should be quarantined. The Secretariat tried to demonstrate that the United States was not likely to make additional headway during 1969 in combatting inflation, and that additional measures of restraint were needed in the fiscal area and possibly also in the monetary area. The EPC as a group did not concur in that line of argument. In general, it was agreed that the direction and intensity of demand management policies in the OECD countries were proper, and that no major changes were needed. There also was general acceptance of the prospect of a marked slowdown in the U.S. economy over the coming months. He had called attention to the facts that the House had passed the surtax extension bill and that the Federal Reserve had made some headway in its program of monetary restraint.

With respect to the U.S. balance of payments, Mr. Brimmer continued, the group did not accept the argument that recent surpluses on the official settlements basis indicated that the United States was making some progress. They felt that the inflows of short-term funds producing the official settlements surplus were not sustainable and resulted in an improper structure of the capital account. Instead, several delegates held that the liquidity balance represented the appropriate measure of the U.S. payments performance. To his surprise, there was some discussion during the meeting of exchange rate realignment, a subject that previously had been avoided. The Germans advanced the suggestion that--if exchange rates were to be revised--it should be done on a multilateral basis. They were immediately challenged by the British, who said they would not join in any further multilateral exchange rate revisions under any circumstances, given the devaluation of sterling in November 1967.

Mr. Brimmer observed that there was a review of fiscal policy at the EPC meeting which was based on a report--already published--by a committee of experts headed by Walter Heller. Although Mr. McCracken stressed the need to take a realistic view of fiscal policy--including its limitations--on the whole, the U.S. delegation considered the experts' documentation as likely to provide a useful guide to action in that area. The Secretariat adopted a suggestion for a study of monetary policy, to be concerned not simply with the effects of policy but also with the institutions through which those effects were transmitted. The U.S. delegation had strongly supported that suggestion, in the belief that there was inadequate understanding of the way in which monetary policy actually worked in various countries. He had volunteered to have someone from the Board's staff participate in the study.

The question of the Euro-dollar market was also considered at the EPC meeting, Mr. Brimmer reported. The views expressed there, and in his later discussions in Rome, were quite similar to those Mr. Daane had reported today. In general, the speakers indicated that while they approved of the direction of Federal Reserve policy they disapproved of the methods being employed. They thought the System should raise or eliminate the Regulation Q ceilings in order to permit U.S. banks to compete domestically for short-term funds. There seemed to be little appreciation of the consequences of an increase in the Q ceilings for domestic monetary policy. The reactions to the proposal for marginal reserve requirements on Euro-dollar borrowings also were similar to those reported by Mr. Daane; the expectation was that the proposed action would have little effect on flows. Just as U.S. reliance on present Q ceilings to draw reserves from foreign central banks was considered improper, so was the adoption of regulations that would have the effect of locking in such funds. There seemed to be a great deal of confusion between the roles of the ceilings on large-denomination CD's and those on consumer-type time and savings accounts; for example, the assertion was made that it was unfair to protect housing in the United States at the expense of housing in Europe. Some people had remarked that all the System had to do was to impose quantitative credit ceilings on U.S. banks. There appeared to be no appreciation of the problems of such a course, including the System's lack of statutory authority to impose quantitative controls.

In Rome, Mr. Brimmer remarked, he had talked with people at the Bank of Italy and with a few commercial bankers. He asked about the action the Italian authorities had taken to control the participation of their banks in the Euro-dollar market, and was told that it was intended to deal with a border problem: currency had been moving out of the country and returning--via Swiss banks--in the guise of legitimate capital outflows. In London he had visited at the Bank of England and with a few Treasury people but had spent most of his time at the clearing banks and at branches of U.S. banks. He had also talked with economists at Cambridge over the weekend. Views in London regarding U.S. monetary policy and the Euro-dollar market were split. In general, the Bank of England people thought the System should not rely so heavily on Regulation Q and should raise the ceilings. Among the clearing banks, however, there was mild applause for the System's recently announced proposals relating to Euro-dollars. Some concern was expressed at those banks about the inexperience of American banks that recently had begun to operate in London. The managers of U.S. bank branches were deeply concerned about the Euro-dollar proposals and were anxious to see the Q ceilings increased. They also raised a few technical questions about the interrelations among the Federal Reserve Euro-dollar reserve requirements regulation, the foreign credit restraint program, and the Department of Commerce program on direct investment.

Mr. Brimmer went on to say he had received the impression that the IMF proposals for a specific limitation on domestic credit expansion in Britain--to which the British Treasury had agreed in connection with the $1 billion standby credit from the Fund--had not been received warmly at the Bank of England or at the clearing banks. There was some feeling that the goal of limiting domestic credit expansion to 400 million pounds in the 1969-70 fiscal year would prove untenable and would result in undue pressure on the gilt-edged market. It was also considered doubtful that the balance of payments target of a surplus of 300 million pounds in the fiscal year beginning April 1 was realistic.

Just before he left London, Mr. Brimmer said, he talked with Mr. Lever, the Financial Secretary of the British Treasury. As the Committee knew, Mr. Lever recently had said in a speech that Britain had no prospect of repaying her short-term debts on schedule and that those debts would consequently have to be refinanced. That statement had caused a stir in central banking circles. He (Mr. Brimmer) personally thought it was unfortunate that such a statement had been made.

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 June 24 through July 9, 1969, and a supplemental report covering July 10 through 14, 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 a sharp upward thrust of shorter-term interest rates as banks and other financial institutions passed through the midyear statement date and interest-crediting period and the Treasury passed from a period of debt repayment to new borrowing. Pressure on the banks, at least psychologically, was also maintained by the proposed changes in Regulations D, M, and Q that were generally regarded as additional evidence of a generally tough Federal Reserve policy. On last Friday, however, a sharp rally developed in the long-term end of the Government market as some market observers, initially at least, found in the decision of a major auto company to cut back its investment program the first evidence of an economic slowdown--evidence that they had long looked for in vain. It would indeed be premature to believe that the markets are over the hump, and in fact long-term Governments lost a good part of their gains yesterday. But the substantial decline in stock market prices over the past few weeks has helped subdue inflationary psychology somewhat. And in this setting, markets for long-term fixed-income securities could be given a real boost by any really hopeful developments towards peace in Vietnam, or by further evidence of an economic slowdown.
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> The Treasury bill market was characterized by a sharp over-all increase in rates in early July, as bank statement day demand for bills was reversed and the

Treasury announced the auction of $3.5 billion tax-anticipation bills. There were large day-to-day variations in rates as well. With financing costs high dealers have been trying to keep their bill positions at a minimal level, with the result that any concentration of either supply or demand tends to have an exaggerated impact on rates. The three-month Treasury bill, which was trading at 6.50 per cent at the time of the last meeting, dropped 43 basis points to just over 6 per cent in the next two days. Rates then rose rapidly, with some backing and filling, and the three-month bill rate reached 7.08 per cent bid at the opening on July 10. In yesterday's regular Treasury bill auction average rates of 7.10 and 7.40 per cent were established respectively for three- and six-month bills, up 58 and 53 basis points from the averages in the auction just preceding the last meeting of the Committee.

Reflecting developments in the bill market, yields on short- and intermediate-term Government coupon securities also adjusted sharply upward. By last Wednesday yields on most coupon issues maturing out to 1974 had risen by 30 to 75 basis points, with yields as high as 7.81 per cent on issues maturing in late 1970 and well over 7 per cent on issues maturing in 1974. Last Friday's rally knocked these yields down by 20 to 40 basis points; most longer-term issues, beginning with the latest Treasury 6-1/2 per cent note maturing in May 1976, actually yielded less on Friday than at the outset of the period. In the corporate market bond prices rose early in the period but then turned down as the calendar of new issues built up rather rapidly. Reception of new issues was rather mixed, but towards the end of the period a large telephone company issue at a record 7.91 per cent yield was very well received and moved to a premium of 1-1/4 points in last Friday's market. Prices in the municipal market, influenced by light offerings, low dealer inventories, and a modest calendar, generally moved higher. That market, however, remains vulnerable to any substantial bank selling and the marketing of even a normal supply of new issues.

One very interesting development of the period--covered in the regular written report to the Committee--was the very sizable increase in small-investor interest in open market instruments, an interest affecting Government, corporate, and municipal securities, bankers acceptances--offered at 8-1/2 per cent--and commercial and financial paper, where yields of 8-1/2 per cent or more are common. One facet of this interest is reflected in the rise of noncompetitive tenders for Treasury bills, and in a steady stream of small investors into our Securities Department seeking advice on how to bid for themselves in a Treasury auction in order to avoid fees or the wide spreads charged by most dealers on odd-lot trades. Noncompetitive tenders in recent auctions have recently been running well over $600 million compared to only $400 million to $500 million a year ago. The flood of odd-lot orders has raised a number of technical problems for the banks and Street firms, and the increase in volume of transactions has tended to aggravate the fail problem.

One would like to think that the current high level of interest rates was encouraging greater savings on the part of the public. To some extent this may be so, but it is evident that the bulk of this small investment demand represents a diversion of funds from the thrift institutions, including banks, and from the stock market. While outflows from thrift institutions over the interest-crediting period were relatively large, they appear to have been met so far with a minimum of strain, mainly by running down liquid assets assembled to meet the drain.

Open market operations over the period had to be flexibly adapted to the day-to-day vicissitudes of the money market, within the context of continuing pressure on the banking system. Banks were again generally cautious in managing their reserve positions, leading to very taut money market conditions before the weekend as the banks attempted to meet anticipated reserve needs early, and then tending to ease off at the end of the statement week. To help moderate those swings, open market operations were typically used to inject reserves before the weekend and then to absorb them through matched-sale purchase agreements at the end of the statement week. An exception to this pattern occurred in the midyear statement week, when the effective Federal funds rate reached a record 10-1/2 per cent before the weekend and weekend borrowing was exceptionally high. By Monday morning the large money market banks had cumulative excess reserves of nearly $5 billion. No attempt was made, however, to offset the money market ease that developed late in that week in light of the high level of borrowing and of net borrowed reserves, and the rapid increase in Treasury bill rates.

While there were wide variations in day-to-day money market conditions, on average the Federal funds rate, borrowings from the Reserve Banks, and net borrowed reserves were about in line with recent experience, as the blue book[1/] indicates. Certainly the over-all impression in the market was that monetary restraint remained in full force. The credit proxy continued to be hard to interpret as the CD drain continued unabated and banks made strenuous efforts to offset the drain by adding to their non-deposit liabilities. In June the proxy--including the sharp increase in Euro-dollars--is estimated to have declined at about a 3 per cent annual rate, in line with earlier projections. After rough adjustments for changes in various non-deposit liabilities, however, the proxy appears either to have shown no change or to have increased slightly.

For July, the blue book indicates that the bank credit proxy, assuming some further growth in Euro-dollars, may decline in a 5 to 8 per cent range, with very rough August estimates indicating that the decline in bank deposits may be slight. In interpreting the proviso clause of the directive, I have been working on the assumption that some allowance should be made for the replacement by the banks of disappearing CD's with other instruments that are not currently measured by the proxy. Thus, while the currently projected decline in the proxy for July at an annual rate of 5 to 8 per cent appears greater than the 2 to 4 per cent rate of decline projected at the time of the last meeting, the proviso clause was not implemented in the belief that the proxy is exaggerating the decline in bank credit, as it has been doing for some time. The collection of additional data on new bank financing methods has been helpful in making additional proxy adjustments, but there remains much to be done in the way of further analysis of the basic statistics.

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

Looking to the period ahead, the System should be absorbing reserves over the next two statement weeks and then supplying reserves in early August. The market is faced with a heavy corporate and Government agency calendar, and the better market tone that developed late last week will be subject to a testing period. The high cost of financing should keep pressure on short-term interest rates, especially as banks continue to dispose of tax bills won in the recent auctions. Additional pressure might be exerted if investors who have temporarily invested in Treasury bills and other short instruments decide that the time to make long-term commitments has arrived. Long-term markets will be especially influenced by the tenor of current economic information, and by developments in Vietnam and in Congress.

The Treasury, as you know, raised \$3-1/2 billion in cash in two auctions of equal amounts of December and March tax bills last week. At the end of the month they will announce the terms for the refunding of \$3.4 billion August maturities. Ideally, an effort should be made to pre-refund part of the heavy \$6.2 billion October 1 maturity as well, but whether or not the market will be able to support so large an operation is uncertain. Early last week most market observers felt that the refunding should be as routine as possible--and even then that it might run into problems. New prospects would be opened up, however, if last week's rally should be consolidated. In the August refunding I would plan to roll over the System's holding of only \$45 million of the maturing note. Should the Treasury offer holders an option in an exchange offering, I would plan to subscribe only to the shorter-term issue in view of the small size of the System holding of the maturing issue.

Mr. Maisel referred to the Manager's statement that he was making some allowance for nondeposit sources of bank funds other than Euro-dollars in interpreting the proviso clause. If Mr. Holmes' statement meant that he would not put the proviso into effect because nondeposit sources of funds were continuing to expand--even though the decrease in member bank deposits plus Euro-dollars exceeded the projection given in the blue book--the procedure would appear to be illogical.

The current blue book noted that data for such nondeposit sources had only recently become available, Mr. Maisel continued. It indicated that funds from such sources had added significantly to the ability of banks to lend in June and that there was no evidence to suggest either a decline or acceleration in the rate of growth of nondeposit funds in July. However, perhaps because the data were still rough, no estimate was offered of the amount that might be added on that account to the July projection of the adjusted credit proxy, which continued to be defined in terms of member bank deposits and Euro-dollars.

Mr. Maisel thought it would be inappropriate for the Manager to make an additional allowance for nondeposit funds when the expected expansion in them occurred. Such an allowance should either be made in both the projections and the series used later to measure the deviations from those projections, or--if that was not possible--the allowance should be omitted from both. To omit the allowance from the series in terms of which the projection was made, but then to include it in the series as it developed during the month, was to compare noncomparable information and to produce biased interpretations.

Mr. Holmes replied that in making allowances for funds raised from nondeposit sources he had been attempting to relate their current levels to those in previous periods. Admittedly, in the absence of good figures for earlier periods such allowances were quite rough, and even with the newly available data a good deal of research was needed in the area. In any case, he thought a failure to make such allowances in the recent period would have resulted in an exaggerated impression of the decline in bank credit, since the evidence indicated that banks had been relying increasingly on nondeposit funds. For example, according to the blue book the bank credit proxy adjusted only for Euro-dollar borrowings declined at about a 3 per cent annual rate in June. But the blue book also offered a rough guess suggesting that if allowance for other nondeposit funds were made bank credit would be found to be about unchanged in the month.

Mr. Daane remarked that he also believed the proxy series without adjustment for such nondeposit funds gave an inadequate picture of actual bank credit developments. Although available data did not permit precise calculations, he thought rough allowances for those funds could and should be made. He was not particularly disturbed by the imprecision of such allowances since he did not think the blue book projections of bank credit should be interpreted rigidly in any case.

Mr. Coldwell commented that the problem posed by the imprecision of any allowances for nondeposit funds might be met by agreeing to accept a wider range of deviation around the bank credit projections before implementing the proviso clause.

Mr. Maisel said he would rather delete the proviso clause from the directive than to widen the range, but in fact he did not advocate either course.

Mr. Daane remarked that he would welcome deletion of the proviso clause.

Mr. Hickman said he would consider it a great mistake to delete the proviso clause. He thought the Board might well consider additional regulatory actions to curtail bank access to nondeposit sources of funds. In the meantime, further research obviously was desirable on means for taking such funds into account in the measures of bank credit.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 24 through July 14, 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:

> For those of us who have been searching intensively for signs that the slowdown in the economy has become visible, these have been trying days, but there are grounds for encouragement. Current statistics for the most part continue to reveal an economy operating with considerable thrust and with inflationary pressures persistent and widespread. But on balance, recent information appears to be in line with our previous expectations and provides little basis for revising the economic projections for the year ahead presented to this Committee at its last meeting. It still seems highly probable that by fall business statistics should present a much clearer picture of a leveling in economic activity and that by the turn of the year real GNP will be growing very little, if at all.
>
> In the quarter just completed, growth in personal income, employment, and industrial production moderated only slightly, and it should be noted that the June advance in each of these sectors was still substantial. The official figures on second-quarter GNP which will be released shortly will apparently show a GNP increase very close to the first-quarter gain. However, in the consumer sector more weakness apparently has been developing than had been anticipated. Despite a pick-up in unit sales of new cars, retail sales declined in both May and June, and sales at department stores and mail order houses seem to have lost much of their earlier buoyancy.
>
> While there may be some grounds for believing that the retail sales statistics are understated, any reasonable upward adjustment in the data would still show that consumers have been reacting to rapid price rises and the erosion of their real after-tax income by holding back on current outlays for goods. Real

takings of consumer goods are reported to be below year-ago levels.

Meanwhile, inventory accumulation has accelerated in recent months. For April and May, book value of inventories grew at an average annual rate of $12 billion, well above the first-quarter increase. Most of the added inventories were in the important durable goods manufacturing industries, largely in consumer and defense products. Stock-sales ratios for durable goods climbed further in May and were higher than at the end of 1966 just prior to the inventory adjustment of 1967. With production continuing to climb and consumption on the soft side in June, another large inventory increase probably occurred last month. This situation will bear close watching, for an inventory adjustment could get under way at any time if sales continue to fall below expectations.

Looking ahead, however, prospects are that the over-all gain in GNP this quarter will be almost as large as in the second quarter, mainly because of the continued momentum in the economy and the temporary fillip in consumption expected from Federal pay increases. However, plant and equipment expenditures should begin to play a diminishing role in expanding over-all activity. How much less is a moot question.

The fixed-investment expenditure figures projected for the remainder of this year are still based on the April-May Commerce-SEC survey, and they were formulated in a period when business expectations probably were more ebullient--and too early to take into account current credit stringencies. Recent scattered reports of curtailments and cancellations in business plans for capital spending may be an important straw in the wind. And if the stock market is, as some people believe, a good leading indicator of investment expenditures, we should be in for some sizable reductions in spending plans sooner or later. In any event, we hope the survey of capital spending intentions of large companies to be conducted by the Reserve Banks will give us more solid information as to whether major changes are now in train.

If growth in plant and equipment expenditures comes to a halt by the end of the year, as our projections imply, much of the forward thrust in the economy will be blunted. Leveling off in investment spending would come at a time when defense and housing expenditures will in all probability be declining and when consumer spending is likely to be sluggish because of the erosion in gains in employment and incomes. As advances in final sales slow abruptly, it seems highly improbable that businessmen will want to maintain current rates of inventory building for any significant period of time. Thus, most sectors could be contributing to a slackening of economic activity by year-end and real growth should drop to levels that would begin to dampen the rise in costs and prices.

In the months ahead, however, any easing in the price advance should be moderate. The recent slowing in wholesale industrial prices probably will be reversed as lumber prices level off after their sharp recent decline and most other prices continue to rise fairly rapidly. The prospect for consumer prices is also for relatively large increases for the remainder of this year. Earlier it had been thought that the advance in food prices would begin to ease this summer, but recent Department of Agriculture forecasts indicate that meat supplies in the last half of this year will be well below--rather than above--a year ago. Higher food prices are thus likely, in large part, to offset any moderation in other consumer price components.

The rapid rise in consumer prices since the start of the year is having a significant impact on the demands that unions are preparing for upcoming negotiations. So far this year, contract settlements, outside of construction, have been few in number and have carried little weight in the average hourly earnings statistics. In fact, gains in earnings have slowed this year, mainly because second-year and third-year wage increases written into long-term contracts were relatively small. But late this year and next year, expirations of major contracts will accelerate. Union leaders think that if the CPI continues to advance at a rapid pace, wage demands of 10 per cent or more a year are almost certain. These would be justified from the union's point of view by price increases of 5.5 per cent or so, and an allowance for productivity gains of 3.5 per cent and a catch up for losses in real wages. These, however, are tentative calculations. Much, of course, will depend on the state of the labor market, the rate of price increases, and the strength of employers' determination to resist wage demands, if profits turn less favorable when actual negotiations begin.

In making economic forecasts, it is, of course, necessary to consider alternative possibilities. Given the momentum in the economy, the timing and dimensions of the slowdown remain uncertain. The outlook for moderating final demands would certainly be less favorable if the surcharge fails to get through Congress. On the other hand, the beginning of troop withdrawals, which presumably will continue through next year, could set spending on defense on a much sharper downward course than we have projected. Moreover, there undoubtedly are some real risks, in light of the continued high rates of inventory accumulation and excessive capital spending, that easing could, when it comes, be more abrupt and severe than we have projected. But without more signs in hand of a cooling-off in the economy, I continue to believe that it would be premature to suggest any significant change in the Committee's posture of monetary restraint.

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

Credit markets and monetary policy by almost any standard one applies to them are quite tight. Moreover, there is a good case for arguing that conditions have tightened further over the past two months or so.

The increased degree of financial market tightness is indicated by key financial flows, by measures of liquidity position, and by interest rates. It is, of course, a little unfashionable to point to interest rates as a measure of tightness. Nevertheless, since around the middle of May mortgage interest rates--measured by the FNMA weekly auction--have risen by about 60 basis points, new high-grade corporate bond yields by about 40 basis points, State and local government yields by about 20 basis points, and the three-month Treasury bill rate by about a full percentage point. For this rise of interest rates not to reflect additional restraint, one would have to believe that inflationary expectations have actually intensified. But I would note that the sharp stock market decline since mid-May appears to represent testimony to the contrary. Inflationary expectations have certainly not disappeared, but they do not appear to be on the rise and may well be moderating.

In part, the interest rate increases, especially in the short-term area, have reflected the recent accelerated contraction in total and nonborrowed reserves of the banking system. Over the whole first half of 1969, total reserves declined at almost a 1 per cent annual rate and nonborrowed reserves at a little more than a 5 per cent annual rate. But in June both declined at close to a 12 per cent annual rate, and our July projection indicates even larger rates of decline in reserve aggregates for that month. Depending on one's view as to how the monetary mechanism works, these declines mirror--or cause--the very sharp June and July reductions in the outstanding total of member bank deposits.

As a result of the deposit declines, banks have dug further into their liquidity, and the usual liquidity ratios have dropped further below their 1966 lows. In an effort to compensate, banks have turned to other forms of borrowing, such as through holding companies or affiliates, in addition to Euro-dollar borrowings. In one sense these new-type borrowings may be said to dilute the impact of monetary policy actions. But in a basic sense they are an indicator of tightness. The rise in such short-term sources of funds tends to reduce the liquidity position of the banking system, and its willingness to engage in future lending, in somewhat the same sense as a rise in short-term borrowing by business corporations reduces their liquidity; the more is borrowed, the less the institutions will be able to borrow in the future without raising interest rates even higher and without exposing their capital structure even further to excessive debtor claims.

Not only has bank liquidity been compressed in these various ways, but other institutions and sectors too have come under more intense pressure. The liquidity squirreled up by savings and loan associations and Federal Home Loan Banks to take care of cash needs during the mid-year interest-crediting period has indeed been called into use. We have only very partial information on the withdrawals from thrift institutions after interest-crediting. Still, what we have suggests that mutual savings banks in New York experienced greater drains than in 1966, while savings and loan associations were not as hard hit as in that year, although they seem to have experienced substantial outflows which were larger than in 1968. Given the reduced rate of net inflow of savings in recent months, and the dim prospects for the future at current market interest rate levels, the institutions appear to have been hit hard enough to require liquidity reductions to accommodate takedowns of existing mortgage commitments, and hard enough to bring into question their ability to continue making new commitments at even the reduced pace of the last month or two.

Pressure on liquidity not only at banks and other financial institutions but also throughout the economy more generally is a natural aspect of monetary restraint, and generally accompanies a reduced rate of growth in the money supply when that occurs in, and contributes to, a period of rising interest rates. Changes in the money supply are most difficult to characterize because the series is subject to a number of measurement problems, because the definition of money varies with the predilections of the analyst, and because the volatility of the series makes it difficult to find dates for comparison that reveal underlying trends.

Our current measures suggest that we have experienced a further slowing in the past couple of months on average in the narrowly defined money supply and in narrow money plus time deposits other than CD's, to pick two of the more popular series. The recent growth in cash items generated by increased Euro-dollar transactions would seem to be exerting some downward bias in these measures, however--a bias that would be greatest percentage-wise in the narrowly defined money supply. While the quantification of any such bias is still being studied, it can be pointed out that the end-of-month series on total loans and investments at banks--which is free of that particular bias--has definitely slowed during the past two months and shows less than a 1 per cent annual rate of increase.

Our projections for July do indicate a further rise in the average level of the money supply, but these funds would be wholly supplied out of a decline in U.S. Government deposits--and only to about half the extent of such a decline at that. They would not represent either new reserves supplied or net new bank credit, and the growth would not appear to be sustainable, in view of the bleak outlook for reserve provision in the weeks ahead, assuming current money market conditions are maintained.

Given the increasing probabilities of a weakening in future economic activity as construction outlays decline and the investment boom simply runs out of steam, and given the recent intensification of monetary restraint, it might be prudent at this juncture to take a little of the edge off of monetary restraint. I do not mean to suggest any dramatic move involving regulatory instruments. But I would suggest that open market operations permit some moderation in pressures on the Federal funds market. Such a moderation would seem to be a natural consequence of a prospective weakening in credit demands, and would not likely lead to any marked resurgence in reserves or deposits, or indeed to any growth at all under existing over-all financial conditions. One would suspect that the monetary problem as we move through summer and into the fall will be one of finding ways to sustain some modest reserve and bank deposit growth, rather than averting an undesired resurgence.

In terms of the directive,[1/] the Committee might wish to give consideration to removing the word "firm" from the phrase "maintaining the currently prevailing firm conditions" in the second paragraph, and to inserting the word "about" before "the currently prevailing". This would permit a little moderation in Federal funds market pressures as part of an effort to keep the present degree of monetary restraint from cumulating further, and would be a marginal step toward setting the stage for an effort to move reserves, deposits, and the money supply to a more sustainable long-run growth path. At the same time it would not signal any premature easing by the Federal Reserve that could in itself trigger a resurgence of inflationary expectations.

Mr. Brimmer said he wondered why Mr. Axilrod thought there was any basis for taking steps at this time to ease pressures on bank reserves, given Mr. Wernick's assessment of the economic

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

situation and the green book[1] projections for the level and composition of GNP.

Mr. Axilrod said he did not think the economic situation called for overt easing at this juncture. He was recommending a slight abatement of the pressure on the Federal funds market in order to facilitate an overt move toward ease later, without committing the Committee to such a move.

Mr. Morris commented that he sensed an incompatibility between the report on financial conditions and the staff's projections of housing starts. With disintermediation now spreading to mortgage lending institutions, he thought it would be difficult to avoid a weaker pattern of housing starts than projected if the Committee maintained its present policy posture.

Mr. Axilrod said he personally thought the odds had shifted toward more slowing in housing activity than projected by the staff; that was one factor underlying his prescription for policy. However, complete information was not yet available on the experience of thrift institutions during the interest-crediting period. A better assessment of the housing outlook would be possible when that information became available.

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

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

I would like to take a little time today to discuss a problem that may be bothering us later this year. This is the question of what effects a modification of Federal Reserve credit policy away from the present policy of severe restraint may have on our international reserve position.

The question of how to protect our reserves has dropped out of sight for over a year now, because the borrowing of Euro-dollars by a relatively few large member banks has done the job for us--albeit crudely and in great gulps rather than neatly and circumspectly. In the eighteen months through June liabilities to foreign branches and other foreign banks increased by the fantastic amount of $11-1/2 billion--a little over $3 billion in 1968, over $4 billion in the first five months of 1969, and nearly $4 billion in the single month of June. Probably well over $1 billion of this borrowing was merely a recapturing of funds that moved out of the United States into the Euro-dollar market--especially in June. The remaining $10 billion or so served to pull in funds from banks, businesses, and others outside the United States, whose assets are ordinarily kept in other currencies, and whose acquisitions of Euro-dollars--or, in some cases, repayments of Euro-dollar loans at London branches--cost their own central banks dollar reserves, potentially if not actually.

Of this $10 billion flow from abroad through the Euro-dollar market to U.S. banks, perhaps $1 billion or more served to offset, in a balance of payments sense, the abnormal movements of funds from the United States during this period into German mark assets and repayments of debts in marks. Another $4 billion or so of the Euro-dollar inflow offset normal U.S. international transactions--transactions other than the abnormal outflows from this country into Euro-dollars or into marks. The rest of the Euro-dollar inflow, amounting to $4.6 billion, increased our reserve assets and decreased our liabilities to foreign reserve holders. We not only protected our reserves. We greatly overfinanced our underlying payments deficit.

Taking this year and a half as a whole, the losses of official net reserves that foreign countries experienced were particularly large for France and Britain, both of which were suffering speculative outflows. On a relatively smaller scale there were reserve losses for quite a few other European countries. On the other hand, Germany, Japan, and many other countries outside Europe were gainers.

In the single month of June, despite a liquidity deficit swollen to about $1-1/2 billion by movements of liquid funds out of the United States, U.S. banks' borrowings of Euro-dollars were so large that our dollar liabilities to foreign reserve holders were reduced by $2-1/2 billion. In June no other major countries gained any significant amount of net reserves except Britain and Switzerland. While Germany reduced its reserves by a large chunk, there were apparently widespread reserve drains for other countries. In the past three weeks there has been a further addition to U.S. banks' liabilities to branches, and further reserve drains for some countries.

The statement the Board issued in proposing a 10 per cent marginal reserve requirement under Regulation M against borrowings by member banks from their foreign branches indicated the relation of the action to domestic monetary policy and also referred to distortions of credit flows abroad. Implicit in the action was also an aim of smoothing out reserve movements if possible--both others' and our own. On this point, some of the considerations regarding our reserve position are these. There is very little positive advantage in greatly overfinancing our underlying deficit. On the contrary, this display of power may have ruffled the feelings of some of our European friends; and in a few cases--perhaps for Belgium, Denmark, and Sweden--the very high Euro-dollar interest rates may be causing internal monetary policies to be more restrictive than they need have been, possibly to our disadvantage. Most important from the point of view of U.S. interests, the further the buildup of our Euro-dollar debt goes, the greater the chances become that later on, when U.S. banks can find cheaper sources of time money at home, they will repay much of this foreign debt in a rush. Their foreign branches would let deposits run off and would also expand their lending, and the result of the whole process, with the underlying U.S. payments deficit still large, might be to pump a flood of unwanted dollars into foreign reserve holders' hands in a relatively brief period, and possibly generate cumulative speculative reactions.

The marginal reserve requirement, with a 10 per cent rate, is obviously not a powerful instrument either to moderate current inflows or to discourage future outflows--as it should do, to some extent, through the automatic lowering of a bank's base whenever the bank reduces the level of its average borrowings. Probably we cannot avoid some future outflows, and possibly the outflows may be rather large.

One may therefore ask whether, for the future protection of our reserve position, it may not be desirable to consider stronger measures to halt the current buildup of borrowings through the Euro-dollar market. In particular, in any consideration of U.S. monetary policy, perhaps we should throw into the scales along with the purely domestic pros and cons any benefits, from the point of view of management of our international reserves, of diminishing the pressures banks now feel to borrow marginal resources abroad. This is a matter that needs to be approached with caution, but on the whole it may well be the case that at the present juncture we would strengthen rather than weaken our international position for the year ahead by actions that serve to slow or stop the Euro-dollar inflow--even though such actions mean uncovering the underlying payments deficit and perhaps also hastening the time when a reflow of Euro-dollars may make international movements of reserves embarrassingly large.

The principal counter-argument, in favor of caution, relates to the SDR activation process. The case for starting the SDR plan on a sizable scale might conceivably still be undercut at this late date by evidence of renewed additions of dollars to the supply of reserves. However, it is fair to say that other countries do expect and would welcome some return flow of Euro-dollars, and they would not necessarily take a large U.S. official settlements deficit in the short run as a forecast for the next five years.

Enlargement of the official settlements deficit by a renewal of speculation on revaluation of the German mark need not greatly concern us. As the experience of last May shows, a run into marks will undoubtedly be partly out of dollars, including

Euro-dollars. But the resulting foreign reserve gains will accrue to Germany only, and the onus for doing something constructive will fall primarily on Germany if we are still resisting inflation. Under such circumstances Germany would certainly abide by its existing commitment not to buy gold from us.

My conclusions, therefore, are as follows. First, we probably cannot avoid some future reflow in repayment of part of the Euro-dollar borrowings of U.S. banks. Second, probably we would be better off in the long run without further inflows, even if the ending of the inflow might hasten the beginning of the reflow. Third, the ending of the inflow will expose to view again the unsolved problem of the underlying balance of payments deficit. As we said three weeks ago in the chart show, in these circumstances it will be important for the United States to show progress toward stabilization.

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

Business activity has great vitality after an unprecedented 100 months of sustained expansion. While retail sales have been sluggish and the rate of growth in physical terms has slowed, inflationary pressures continue to be strong.

Industrial production is vigorous. While additions to inventories are large in some areas, over-all inventory ratios are within the range of recent months, which is low by historical experience. Total employment, including employment in construction, rose substantially in June, and the unemployment rate dipped one-tenth of 1 per cent to 3.4 per cent. Recent wage increases written into collective bargaining agreements add significantly to strong cost-push pressures. Corporate profits are generally high, with bank profits showing extraordinary advances. The most recent price statistics are not as terrible as they were in earlier months, but they are still bad. There are frequent reports of increases in posted prices. I am not persuaded that the recent slowing in the rate of advance of price indices represents a turning of the corner in the battle against inflation.

The balance of payments situation continues to be discouraging. The recorded liquidity balance for the first half of 1969 is estimated to have been in deficit to the extent of $5.8 billion on a seasonally adjusted basis. While the liquidity deficit has probably been distorted by the pull of high Euro-dollar rates on U.S. investors, it seems likely that our trade surplus for 1969 will be very small, and that the liquidity balance for 1969 will show a deficit larger than any in recent years.

An extension of the income tax surcharge is essential. Yet, the affirmative vote in the House to extend was very narrow, and the Senate Finance Committee appears casual about the need as it arranges hearings to consider tax reforms along with the proposed surtax extension. At the same time, people in various places in Government talk about controlling interest rates and other manifestations of a booming economy not adequately curbed by general fiscal and monetary policies. The course ahead for sound fiscal policy is very delicate. It seems likely that monetary policy will continue to bear the major burden of fighting inflation.

Business demands on the credit markets remain intense. But the rate of growth of bank credit and the money supply continue to be moderate. Indeed, there appears to have been little change in bank credit in June. Bank liquidity is very low. Rates of interest in the money and capital markets encourage more disintermediation not only in the commercial banks but also in the savings banks and savings and loan associations. The thrift institutions came through the midyear interest-crediting period satisfactorily, but if market rates advance further, the thrift institutions must be especially cautious in the administration of their resources. We must continue to be mindful that, as the banks develop and use new ways to get funds, various statistical series are less meaningful in measuring changes in bank credit and the money supply. The statistics we have been accustomed to use probably underestimate the expansion of bank credit that has been going on.

The strength of the economy and the inflationary psychology, in my opinion, counsel a continuation of about the same degree of monetary pressure. It is important that banks exercise greater selectivity in loans. High cost of credit is not enough. Restricted availability is essential.

I continue to feel that it would be unwise at this time to make any change in the interest rate ceilings under Regulation Q.

I think it would be desirable for the Board to move forward to amend its Regulations D, M, and Q along the lines previously announced. These include (i) amending Regulation D to plug the loophole with respect to cash item deductions in connection with Euro-dollar transactions; (ii) amending Regulations D and Q to bring under the regulations certain funds obtained by banks from a transfer of assets under repurchase agreement; (iii) amending Regulations D and M to impose reserve requirements on increases in Euro-dollar takings; and (iv) amending Regulations D and Q to bring under the coverage of those regulations a member bank's liability on certain so-called "Federal funds" transactions with customers other than banks. It should be possible to make the first two amendments promptly. The other two will, of course, have to await further public comment and analysis in the light of such comment.

Although the 6 per cent discount rate is out of line with other rates, we see no need for an increase for administrative reasons. I would not favor an increase in the discount rate at this time while the course of the surtax extension continues to be delicate.

Open market operations may be called upon to cushion adjustments incident to action by the Board amending its regulations. Taken together, open market operations and the various amending actions should keep up the pressure of monetary restraint, with no change from the recent atmosphere of firmness.

Looking to open market operations in the coming weeks, I think they should confirm a continuing policy of restraint. Such confirmation might be evidenced by member bank borrowings between $1 billion and $1-1/2 billion; net borrowed reserves between $1 billion and $1.3 billion; and a Federal funds rate in a range of 8-1/2 to 9-1/2 per cent.

I have two suggestions with respect to the first paragraph of the draft directive. The suggestions involve the description of developments with respect to bank credit and the balance of payments.

I suggest that the reference to bank credit be revised to read, "In June there was little change in bank credit . . . ." As the blue book indicates, non-deposit sources of funds other than Euro-dollar borrowings may have about offset the decline in the bank credit proxy adjusted for Euro-dollar takings.

The language of the draft directive dealing with the balance of payments emphasizes the large surplus on the official settlements basis, and deemphasizes the drastic increase in the deficit on the liquidity basis. I would prefer to reverse the emphasis, and therefore suggest the following language:

"The over-all balance of payments deficit on the liquidity basis rose sharply in the second quarter; there were large outflows into German marks and into Euro-dollar deposits, and there was no significant improvement in net exports. In contrast, there was another large surplus on the official settlements basis as U.S. banks borrowed heavily in the Euro-dollar market."

I have no suggestions with respect to the second paragraph of the directive.

Mr. Francis said that in his opinion monetary actions since last December had been appropriate, and the dampening effects on total spending should appear in the second half of the year. Both the money stock and the monetary base had increased in the last six months at less than half the rates of the previous two years. At the same time, growth of total member bank reserves and other aggregates had also been restricted.

Monetary restraint was indicated by almost any monetary aggregate one chose to look at, Mr. Francis continued. However, as was pointed out in the staff's well developed chart presentation at the last meeting, the choice among the alternative policy targets was not a matter of indifference. As he saw it, the Committee was faced with a two-fold problem of choosing a measure which would serve both as an indicator of monetary influence on the economy and as the controlled policy target for short-run operations. First, the growth of the monetary aggregate selected should be associated after a brief lag with the course of economic activity, as indicated by changes in GNP. With such a guide, the System could relate an observed growth of the aggregate over the recent past and planned growth in the near future to the growth of total spending, real product, and inflation. Second, the Committee should have an operating framework within which it could determine within a reasonably short period the effects on the monetary aggregate of open market operations, changes in reserve requirements, or other System actions.

In that regard, Mr. Francis felt that the staff's analysis in last month's chart presentation of movements in bank credit, reserves, and the money stock was an important step toward more quantitative monetary management. The similarities and disparities between movements in bank reserves and money seemed to be an area which deserved further research effort. On the surface, the 2-1/2 to 3 per cent rate of growth of total reserves the staff had projected for the second half of this year, and the 4-1/2 per cent growth rate projected for next year, seemed to be at the high end of the desirable range. The trend growth in total reserves from 1957 to 1965 was 3 per cent per year, and at the present time with the disintermediation of time deposits, a somewhat slower growth in reserves seemed desirable.

However, Mr. Francis observed, the Committee was left with uncertainties with regard to the use of member bank reserves as a target variable on at least two grounds. Although a reserve target appeared to be a usable guideline for operations until more information was acquired, he felt that the Committee should investigate the relation between bank reserves and total spending, if it was to use the growth of total reserves as a policy target.

The other area of uncertainty, Mr. Francis continued, related to the net increase in System holdings of securities over the next six months that would most likely achieve a given target growth of total reserves. Although purchases and sales could be adjusted continually during the period in pursuit of the Committee's target, he thought exploration of a framework within which reserves could be closely controlled should be undertaken.

As might be inferred from what he had said, Mr. Francis observed, he thought the establishment of the subcommittee for research on the structure of the directive had been very desirable. He hoped the studies arising out of that subcommittee would proceed without delay. Meanwhile, he suggested that, until the studies of the subcommittee were completed, the Federal Open Market Committee should specify a target growth rate or range of total reserves at least in the proviso clause, although he would prefer including total reserves in the main instruction to the Manager, with money market conditions in the proviso. Continued use of bank credit in the proviso clause would not be consistent with the staff's assessment of bank credit as an indicator or target for operations.

Mr. Francis suggested for the Committee's consideration a second paragraph of the directive reading as follows: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted so that on average over the next three months total member bank reserves (seasonally adjusted) will grow in the range of a zero to 1 per cent annual rate. Over short periods of time the Manager may deviate from this course in order to smooth money market conditions, but any such deviations must later be offset."

Mr. Kimbrel reported that, on the basis of statistical evidence, there had been some slackening in the Sixth District's heat wave of activity. That was most noticeable in the behavior of consumer spending. Reports for June showed auto sales of only one major manufacturer above last year's level. On the other hand, the industry was pleased that auto inventories had steadily declined. The demand for all types of consumer credit, especially for auto loans, had remained strong.

Outside of consumer activity, Mr. Kimbrel noted, the only other soft spots of any consequence in the region were construction and certain farm areas that had been hit by unusually hot and dry weather. With those exceptions, business activity was still extremely strong, judging from the statistical indicators.

However valuable those statistical indicators were, Mr. Kimbrel continued, he thought one sometimes learned more from Reserve Bank directors, other contacts, and special spot checks. Calls on savings and loan associations revealed that the loss of savings over the mid-year reinvestment period was not excessive and was about in line with the 1968 experience. He also found no justification for fears that this period might be a problem to the banks. On the contrary, in early July the larger banks increased their consumer-type time deposits substantially.

To get special insight into trends, Mr. Kimbrel said, he had asked all of the Atlanta Bank's head office directors and various branch directors for special reports on capital spending and inventories insofar as those had been affected by credit conditions. As one might suspect, the directors from Florida saw little or no evidence that financing costs or credit availability had had visible effects. Yet, he was impressed with the fact that the majority of the District directors offered the opinion that credit tightening was beginning to have some impact. Few were as bearish as one Alabama director who found considerable pessimism about economic activity in his State for the last half of 1969 and who cited several examples of companies shelving previously announced capital spending plans. Even there, the number of companies involved was small. Several directors, however, thought that while previously committed programs would be carried out, next year was more of a question mark. Several revealed that work on drawing boards had diminished recently. Others mentioned reductions in new orders, attempts to reduce inventories, and evidence of slower collections. Commercial construction was still going ahead as scheduled, but design work had fallen off and some period of adjustment seemed to lie ahead.

In that connection, Mr. Kimbrel continued, perhaps the most pertinent comment came from a director in the construction business. Despite some bearish developments, he reported a general feeling throughout the construction industry in his local area to the effect that the economy was entering only a temporary period of adjustment and that long range prosperity for all was just around the corner.

If that feeling was typical in other sections of the country, and he presumed that it was in many, Mr. Kimbrel thought the talk of recessionary fears and vanishing inflationary expectations was highly premature. And that suggested that it would take more than a slight moderation in business activity to cause significant changes in capital spending plans. Therefore, while he did not advocate a more restrictive policy at this time, he thought the Committee should maintain its present posture whether even keel considerations were applicable or not.

Mr. Bopp remarked that banks in Philadelphia reported that they were operating under considerable pressure; but they also reported that the pressure was still livable. Contrary to earlier hopes, there had been no unwinding of financial pressures after the tax settlement date. However, the lids which banks had imposed on loans and a seasonal leveling off in loan demand were taking some of the bite out of the deposit squeeze. Several banks expected deposits to be less of a problem because they believed that rate-sensitive CD's were about gone. Some, however, looked for continued attrition in the absence of an increase in the Regulation Q ceilings. In short, although restraints were severe, they did appear to be, as banks said, livable. He believed the existing degree of pressure should be maintained.

There were two matters, however, which Mr. Bopp thought should be watched closely. One was commitments. Both the quarterly survey of loan commitments and recent conversations with bankers in Philadelphia indicated that the volume of commitments was still large. If customers were to attempt to take down those commitments in any substantial quantity, some banks could be in trouble.

The second was Federal funds, Mr. Bopp continued. Philadelphia banks were planning to rely more heavily on Federal funds to ease any adjustments ahead, and a number of discount officers had reported that banks in their districts had similar plans. It struck him, however, that some of those banks might be overly optimistic about the cost and availability of funds.

Turning to the real sector, Mr. Bopp said he believed that signs of moderation were too few for him to conclude other than that the bite of restraint was yet to appear. His staff was in essential agreement with the estimates of the Board's staff for GNP in the quarter just ended and the quarter ahead. Locally, labor markets were very tight, with unemployment in June as low as in any previous month.

Even allowing for the existence of lags, Mr. Bopp added, the response of the real economy to monetary policy was less than he would like to see; prices were still increasing at an alarming rate. Therefore, the appropriate policy for the next four weeks, in his opinion, was to maintain the existing degree of restraint.

Mr. Bopp remarked that the proposal for a reserve requirement against Euro-dollar borrowings was an indication to other countries that the Federal Reserve was aware of the problems which Euro-dollar borrowings might have created for them. In addition, it might counter the widespread belief, which had added to the psychology of inflation, that reserve-free Euro-dollar borrowings made monetary policy ineffective.

Mr. Bopp said he wished he knew what to do about the discount rate other than to observe it, to use Mr. Garvy's phrase. The Philadelphia Bank's directors felt that more should be done to bring inflation under control. Since the discount rate was the only monetary policy instrument over which they had an influence, a majority were restive about the present rate. Yet, a one-half percentage point increase seemed hardly enough and a larger rise would be too much. He was certainly open to persuasion on the subject.

The draft directive as modified by Mr. Treiber seemed appropriate to Mr. Bopp.

Mr. Hickman recalled that at the last meeting of the Committee he had expressed a strong preference for a moderately restrictive monetary policy that could be pursued until inflationary pressures were brought under control, without inducing an actual decline in real output. The economic situation leading to that policy proposal remained virtually unchanged at the present time: current price pressures and widespread expectations of continued inflation persisted, while most of the available economic information pointed to a further slowdown in real economic activity.

Recently, Mr. Hickman said, an informal survey of the 1970 capital appropriation plans of several major Fourth District firms had been conducted by the Cleveland Bank. The survey was still under way and would probably be extended nationally. However, the preliminary results, based on a small sample, indicated that current high interest rates and limited availability of credit, as well as a growing conviction that an extremely restrictive fiscal-monetary policy would slow the economy significantly, were having a decided effect on present plans for capital expenditures next year and beyond. Thus far, it had been found that cutbacks in appropriations were planned in such industries as rubber, steel, railroads, containers, automotive, and petroleum. If plans to reduce capital expenditures were as widespread as he suspected, the Committee might be confronted with a major downturn in 1970. He firmly believed that a policy of moderate restraint, if pursued patiently, would eventually have been successful in bringing inflation under control without inducing a business contraction, although it might be too late for such a policy now. He continued to fear that the Committee's present severely restrictive monetary policy would force it to swing to the side of ease while inflation was still under way.

Mr. Hickman commented that the Treasury was entering a period of extensive financing in which even keel considerations would influence monetary policy to some degree. That even-keel period would provide an opportunity to make a modest first step towards a return to moderate growth in the reserve aggregates and bank credit. By moving now, under the guise of even keel, the Committee should be able to minimize the effect on expectations of that minor change in policy. On the other hand, if the Committee attempted to provide sufficient credit to accommodate the Treasury's needs plus meeting minimal private requirements, it should avoid a return to excessive growth in the monetary aggregates.

Mr. Hickman said he did not support the staff's draft of the directive since it implied endorsement of present policy, which he thought had been, and continued to be, overly restrictive. However, he could perhaps be persuaded to accept the draft with Mr. Axilrod's proposed modifications. As at the last meeting, he would prefer to leave the discount rate where it was for political and economic reasons, and he would not alter Regulation Q ceilings at this time, even for large-denomination CD's. As a matter of fact, he would suggest to the Board of Governors that the sale under repurchase agreement of participations in loan pools by banks at high rates be brought under the provisions of Regulations D and Q. That form of bank financing was mushrooming in the Fourth Federal Reserve District and was becoming an increasing problem in regulating bank credit.

Mr. Sherrill observed that in preparing for this meeting he had found his uncertainty growing for two reasons. First, some of the results he had expected by now from the System's policy of restraint had not yet unfolded. Secondly, he had anticipated that the issue of the surtax extension would have been resolved by this time.

Mr. Sherrill said it was clear from the data that a great deal of monetary restraint had been achieved in the financial world. However, it was disturbing to observe that such restraint had had little effect so far on the world of the real economy and on the expectations of businessmen. There were signs of modest effects in some sectors of the real economy, but assurance was lacking that they signaled the beginning of a significant moderation of the expansion. Monetary restraint finally was affecting the expectations of bankers, who were now beginning to believe that the System was determined to bring inflation under control. Some businessmen might be starting to doubt that the boom would persist, but on the whole their views had evidently been influenced little thus far.

Looking ahead, Mr. Sherrill continued, the most significant unresolved question was the outcome of the surtax extension bill. Since that outcome was still in doubt, he favored maintaining the present posture of monetary policy. If any modest policy moves were to be made, he thought they should be on the side of restraint rather than of ease. He believed the Board should adopt the proposed restraints on Euro-dollar flows, eliminate the cash-item credit arising in connection with Euro-dollar transactions, and also proceed with the proposed regulation on Federal funds transactions. However, he would not favor an increase in the discount rate at this time or the imposition of controls on commercial paper issued by bank-holding companies--measures which he would consider to be undesirably large policy moves under present circumstances.

Mr. Sherrill said he found the staff draft of the directive acceptable.

Mr. Brimmer commented that he would not favor any relaxation of monetary restraint at this time, and accordingly, he could not accept Mr. Axilrod's proposed modifications of the directive. In his judgment it would be appropriate to continue about the current degree of restraint. He shared Mr. Treiber's view that the emphasis of the balance of payments statement in the draft directive was unfortunate, and he would support Mr. Treiber's suggested rewording. He also agreed with the new language proposed by Mr. Treiber concerning bank credit developments.

Mr. Brimmer said he was intrigued by the increasing expressions at Committee meetings of views on monetary policy along the lines of the Chicago school. He thought it would be most unfortunate if the Committee were to adopt a purely quantitative approach to monetary policy such as Mr. Francis was recommending.

With reference to the issue raised earlier by Mr. Maisel, Mr. Brimmer indicated that even though data were unavailable except for the very recent period on nondeposit sources of bank funds other than Euro-dollars, it was apparent that banks were increasing their reliance on such sources. He thought the Committee should take that development into account. He agreed with Mr. Treiber that the regulations pertaining to bank use of such funds should be tightened.

Mr. Brimmer said he shared the concern expressed by Mr. Sherrill about the lack of response in the economy to the policy of restraint and about the considerable uncertainty surrounding the extension of the surtax. In particular, he was disturbed about reports that action on the tax bill might be delayed until September. In the circumstances, he felt--as he had indicated earlier--that the Committee should not deviate from its present policy course. He recognized that such a policy might prove to be a mistake, but given the clouded outlook for continued fiscal restraint he would accept the risk of overstaying the present degree of monetary restraint.

Mr. Maisel said he wanted to comment again on the problem of making certain that the Committee's directive and open market target were clear and not shifted inadvertently. The question he wanted to raise was what was meant in the directive by "maintaining firm conditions," or by "continuing current restraint," as called for by some previous speakers. His purpose was to continue the type of analysis made by Mr. Axilrod today--an analysis which he (Mr. Maisel) had been happy to hear. In contrast to Mr. Brimmer, he took it that Mr. Axilrod had been discussing what underlay current restraint and how restraint should be measured, and the necessity of avoiding any simplistic views in attempting to do so. It was not too useful if the words of the directive had substantially different meanings to different members of the Committee.

Mr. Maisel remarked that if one returned to the blue book prepared for the April 29 meeting--since which time the Committee had attempted to maintain firm conditions--he would note that at that time net borrowed reserves were projected to be somewhat under $1 billion; member bank borrowing under $1.2 billion; the Federal funds rate in the range 7 to 7-3/4 per cent; and the three-month Treasury bill rate between 5.9 and 6.2 per cent, with similar related rates on short-term money market paper. When one looked at the data for the past week or two and the current projections, he noted that all of those variables were at much higher levels. In May, net borrowed reserves and the amount of borrowing had moved upward out of the projected range and since then had been held about constant. Meanwhile, in a period of under two months, the Federal funds rate, the bill rate, and other money market rates had risen by 15 to 20 per cent. Not surprisingly, that tightening had been accompanied by an acceleration in the rate of decrease in the monetary aggregates.

Anyone looking at the record would assume that the Committee had returned to a target defined purely in terms of net borrowed reserves, Mr. Maisel said. After those reached their new level in May, they had been held more or less constant. As one would expect--with a banking system that was rapidly losing liquidity--that had meant higher short-term rates and a fall, or a slower growth, in all of the money and credit aggregates.

Mr. Maisel thought the record of the past made clear that net borrowed reserves by themselves formed a most illogical target. At the same time, the longer the Committee stayed with it, the more difficult it would be to change the target to a more logical one without a major impact on expectations. The green book indicated that the economy was at an inflection point in terms of the growth in GNP. At the same time, monetary liquidity was also much less. What effect of maintaining the current target should be expected in terms of the monetary and credit flows on the economy? Clearly, keeping money market conditions at their current levels should lead to an increasing impact on flows in the credit markets. With demand increasing at a slower rate, even with large liquidity requirements, the net effect would probably be a continued fall in the availability of money and credit.

The current stance, Mr. Maisel said, had been actually one of tightening by allowing or forcing short-term rates to rise. Even if those rates were now held constant, it would still be a continued tightening because it would mean a greater restraint on the supply of funds relative to a decrease in the demand for them.

Mr. Maisel remarked that the problem of avoiding a sudden shift in expectations and a rapid build-up in the flows was becoming more and more difficult. A failure to shade all of the targets on the less firm, instead of on the more firm, side greatly increased the probability of a future need for a sudden shift with a burst of expectational changes in both money market conditions and the flow of funds. To avoid a sudden shift, the Committee should start moving gradually now.

Mr. Daane said he found himself very much in agreement with Mr. Sherrill on the subject of monetary policy today. Granting the persuasive logic of the staff's analysis and of their projections of developments in the latter part of the year, he thought the Committee was still faced with an economy that was thrusting strongly upward and with inflationary pressures and expectations that had shown little or no signs of diminishing. Until there was harder evidence of a slowdown and assurance of support from fiscal policy, he thought it would be premature to ease off from the current degree of monetary restraint. Under current circumstances, the risks of a slight accentuation of restraint seemed smaller to him than those of easing off. The forthcoming Treasury refunding suggested the desirability of maintaining an even keel at present, but if there were errors in executing such a policy he would hope they would be on the side of restraint.

Obviously, Mr. Daane remarked, he would not favor the changes in the draft directive suggested by Mr. Axilrod. He would, however, strongly support the amendments proposed by Mr. Treiber. He had independently arrived at the conclusion that the emphasis was wrong in the staff's proposed statement on the balance of payments, and he thought the language Mr. Treiber had suggested would meet that difficulty.

Mr. Heflin remarked that business conditions in the Fifth District seemed to be paralleling rather closely those reported for the nation as a whole and appeared to warrant no extended comment. He thought it might be worth noting, however, that the Richmond Bank's last two surveys showed a marked diminution in the degree of optimism expressed by both bankers and businessmen.

At the national level, Mr. Heflin said, the latest data suggested that, despite recent signs of moderation, the boom continued under considerable forward momentum. As a matter of fact, it seemed to him that some of the signs of moderation the Committee was looking at a few weeks ago were no longer present. Automobile sales had staged an impressive comeback and the latest contract award figures cast doubts on the permanency of the recent more moderate pace of construction activity. He found it rather discouraging that the green book's estimate of GNP growth in the second quarter had been revised upward again and now showed virtually no change from the first-quarter rate of growth. The staff's advance estimates had been consistently on the low side over the past several months and, in that light, the latest figures were not at all reassuring.

But it seemed to Mr. Heflin that the most significant evidence before the Committee today was not the latest business statistics but rather what he viewed as growing indications of a rather substantial turnaround in expectations in both the financial and the business communities. The most dramatic evidence of such a turnaround was, of course, the steep decline in stock prices over the past six weeks. But, in addition to that, he thought a substantial escalation of uncertainty had become evident in most other financial markets as well. The recent shift of investment interest to long-term bonds suggested that the market might have swung over to expectations of a significant business slowdown, and press and trade association reports of retrenchment in business capital and inventory plans seemed to have multiplied lately, along with talk of a business recession. In brief, the Committee could be facing a prospect that, even with the present degree of policy restraint, total spending might be cut back rather more abruptly than the staff projections envisaged.

So far as policy was concerned, Mr. Heflin said, he was willing to concede that, considering only the latest business data, an argument might be made that there was not yet enough restraint. He was also quite aware of the possibility that because of growing bank reliance on nondeposit sources of funds the Committee's key money and credit aggregates could be understating current credit availability. But even allowing for that, he believed the Committee had achieved what was by any measure an impressive degree of restraint and that it was beginning to see some pretty solid signs of a payoff ahead. Moreover, it seemed to him that any overt tightening move at this time involved a considerable risk of touching off disorderly conditions in financial markets, with a sharply increased probability of larger cutbacks in capital spending than the Committee had been bargaining for. Accordingly, for the present he was in favor of maintaining the existing degree of pressure, keeping the money market and reserve variables in the general range prevailing over the past several weeks. The draft directive with the changes proposed by Mr. Treiber was acceptable to him.

Mr. Clay commented that despite the System's highly restrictive credit policy of past months, indications of the needed response in economic developments were rather limited. Some signs of moderation could be found in the real economy, but evidence of restraining impact on prices was largely lacking. In fact, contrary to earlier hopes and expectations, price inflation in 1969 had accelerated rather than slowed down as compared with 1968.

Mr. Clay noted that the inflationary environment of the economy and the future pressure of costs on prices had been underscored recently in Kansas City, where building construction had been shut down for over three months because of strikes. A settlement had been reached with one of the unions on July 13 which provided for a 67 per cent increase in wage rates over a three-year period plus substantial additions to fringe benefits. Other craft union negotiations were still under way.

The aim of System policy, Mr. Clay continued, was to bring about a gradual, orderly reduction in the rate of economic growth, the effect of which would work its way through the economic processes to reduce the inflationary pressures on prices. Developments to date suggested that the rate of increase in some sectors of the real economy had shown some decline, but that decline had not been accompanied by any dampening effect on the wage-price spiral. Even after allowing for some expected lag in price adjustment, recent developments posed a question as to whether an acceptable degree of adjustment in economic activity, particularly employment, would prove to be adequate to bring reasonable stability of prices.

Mr. Clay observed that no one knew just what the future pattern of economic developments would be. The Board staff projections might be viewed as a fairly favorable sequence of events in terms of an orderly adjustment. Yet, assuming those projections--leading to essentially no over-all economic growth and unemployment of 4-1/2 per cent--were correct, the accompanying projections of prices slowing to a 3 per cent rate of increase could hardly be viewed as a successful outcome in terms of price restraint. Whether such was to be viewed as a satisfactory course of events as the record unfolded would need to be approached by way of total public policy and not monetary policy alone.

The appropriate course for monetary policy at present was to continue essentially unchanged, Mr. Clay said. However, in view of the increasing degree of stringency that had developed recently in financial institutions, notably commercial banks, and in financial markets, it seemed best to avoid further intensification of such pressures.

Mr. Clay said the draft policy directive as modified by Mr. Treiber appeared to be satisfactory.

Mr. Scanlon remarked that he had nothing to add to the general economic round-up presented in the green book. However, he continued to be puzzled by the Commerce Department's estimates of retail sales. The reported sales of certain sectors appeared inconsistent with other evidence and the reported sales of large retailers appeared inconsistent with the Commerce Department totals.

Pressures on resources in the Seventh District continued strong with no convincing evidence of any over-all easing, Mr. Scanlon continued, even though Chrysler's announced cutback in plans for expenditures on new plant and equipment had been widely publicized. Demands for labor remained intense, with unemployment showing no significant change. With the model changeover getting under way in some auto plants, a small rise in unemployment claims had been reported in Michigan.

Steel production continued at high levels and above expectations of industry analysts, Mr. Scanlon indicated. Current prospects were for less than seasonal declines in production in in line with the "optimistic" projections of industry officials. Sales of domestic cars in June exceeded those of a year ago, the previous record for the month. The performance varied by make and model.

Mr. Scanlon commented that prices of commodities and services continued to rise sharply as reflected in the official series, public announcements by individual companies, and reports received from firms in the District. He concurred with the green book on the outlook for food prices. In that area, as for retail sales, the currently available survey data might not merit full confidence, however.

Country banks in the District continued to report only moderate demand for agricultural loans, Mr. Scanlon said. That was consistent with their volume of such loans and their reserve positions. Production credit associations, however, reported large increases in loans to farmers. That raised the question whether country bankers were selling funds instead of providing credit service locally at compensatory rates. Further, did the "Q" ceilings tend to encourage that type of performance? It probably would be easier for rural bankers to establish competitive rates on local loans if they were "forced" to pay market rates for deposit funds. The Chicago Bank's current survey indicated that prices of farm real estate had leveled off and

In recent discussions with business economists associated with major firms in the Seventh District, Mr. Scanlon said, no reports had been obtained of cutbacks in plans for capital expenditures in 1969. It was asserted generally that plans were not likely to be scaled down because of tightness in money and capital markets but that expenditures might not reach planned levels because of shortages of materials or labor. However, the Chicago Bank had received a number of suggestions that plans for 1970 might be substantially below those for 1969, in part because some large projects would be substantially completed in the current year and in part because some firms had reached practical limits in debt-net worth ratios.

Loan demand was reported to be continuing strong, Mr. Scanlon added, with some shift back to banks as rates rose on commercial paper. Loans to metal manufacturers, utilities, mining, and foreign firms showed smaller increases--or greater declines--in June than a year ago. Larger increases than a year ago were reported in loans to manufacturers of soft goods and in trade and services. Chicago banks continued to be large borrowers of Euro-dollars and Federal funds and continued to make moderate use of the discount window.

As to policy, recent changes in monetary and credit aggregates appeared consistent with attainment of the Committee's policy objectives, Mr. Scanlon said. Continuation of the recent trends in aggregate monetary and credit measures appeared appropriate. The staff draft of the directive with the changes suggested by Mr. Treiber was acceptable to him.

Mr. Galusha commented that a recently completed survey by the Minneapolis Bank showed that country bankers had now also become reluctant lenders, at least in their own communities. Many reported having made loans more costly, and some that loan requests were being refused. In the Ninth District, there were considerably fewer country bankers than there were three months ago who were looking for new accounts. But that was not to say that a marked shortage of loanable funds had developed. His suspicion, partly borne out by the data, was that country bankers had become more interested in lending to their city counterparts than to farmers. The extent of their participation in loan pools as against their direct loans was not measurable but, as Mr. Hickman had observed, it might be significant.

Turning to Committee policy, Mr. Galusha said the report on retail sales given in the green book supplement was encouraging. It made the projection for plant and equipment spending given at the Committee's last meeting by Mr. Partee and his associates that much more plausible, and it argued--quite persuasively in his judgment--against further monetary restraint. Implicit in the green book and explicit in Mr. Wernick's and Mr. Sherrill's as a paraphrase of Mr. Thoreau: Most men--and all money managers--live lives of quiet desperation. A candid appraisal of the green book statistics could provide only exceedingly modest comfort about the Committee's current progress; yet, the green book also presented a soothing picture of reversals two and three quarters away. It would be easy to dismiss that as a mirage.

Indeed, Mr. Galusha continued, a pronounced slowing in the pace of economic advance was still in the future; and that being so, he thought the Committee should continue with the policy of the recent past. But the expectation that a slowing would come was logical and defensible given the degree of restraint that had been attained, even though the man who would predict the timing was brave indeed. That should not deter the Committee from using the time lag to its advantage. Some hard thinking should be underway about what the best strategy would be once a pronounced slowing had become apparent. Almost certainly, the Regulation Q ceilings would have to become less restrictive; and the time for doing something was perhaps not too far off. But, as he had said, leaving policy unchanged would seem to be the prudent course for now.

Mr. Galusha said he could accept, without alteration, the draft directive provided by the staff but he could also live comfortably with the changes Mr. Treiber had suggested.

He would add only that as he interpreted a "no change" policy, it required that the Manager provide such reserves as would be needed if and when the regulation eliminating from cash items the amounts generated by Euro-dollar transactions was implemented.

Mr. Swan said he had little to add to the comments already made on the general business situation. He would note that in the Pacific Coast States the unemployment rate had edged up in June--from 4.2 to 4.4 per cent--in contrast to the decline nationally. He would also report an interesting comment by the head of one of the District's large State-wide banks, to the effect that inquiries received at his bank from potential new borrowers--those seeking new banking relations--had dropped off significantly in the last few weeks. Although that bank had tightened its lending standards appreciably in the period, less time was being spent in saying "no."

Mr. Swan then remarked that while he recognized the problems in defining "current policy," he shared the view that the Committee should maintain its present posture, in light of the general economic situation and the unfortunate lack of action thus far on extension of the surtax. But, while he thought the present firm conditions should be maintained, he would want the Manager to be alert to avoid further tightening regardless of the source of the pressures. He favored adoption of the proposed regulation relating to cash items generated by Euro-dollar transactions, but like Mr. Galusha he would not want the implementation of that regulation to be a source of additional tightening.

Mr. Swan said he favored the changes in the draft directive that Mr. Treiber had proposed. He would also suggest deleting the word "further" from the opening statement reading " . . . expansion in real economic activity, after moderating slightly further in the first quarter . . . ." The reference implied by the word "further" was to the third and fourth quarters of 1968, and in his judgment that was now too distant a period to refer to in a directive paragraph dealing with the current economic situation.

Mr. Coldwell remarked that, perhaps because of his concern with developments in the economy or with the trends he saw under way at banks and other financial institutions, he thought the Committee was nearing a crucial policy point if it was not there already.

Signs of some slowing in the rate of economic advance were evident, especially in housing construction, employment, personal income, and retail sales, Mr. Coldwell continued. On the other hand, industrial production, nonhousing construction, and plant and equipment spending still remained strong. Whether those trends would persist, forcing a collision and eventual retrenchment, or were just temporary depended to a large extent upon the System's success in restraining credit demands. It seemed to him that the fundamental economic forces were in effect riding a fence and could be pushed toward a slower or a faster pace. Psychologically, the System appeared to have begun to introduce some doubts in the minds of stock market investors and a few businessmen and consumers. But the majority of the business and consumer spending decisions were still being made on the assumption of further inflation. Given the recent wage settlements, increases in taxes and interest costs, and the advances already made in industrial prices, it was scarcely surprising that one logical interpretation would be that a cost base had been laid for sizable future price increases.

The financial trends and prospects were even more worrisome to Mr. Coldwell. If, indeed, there were to be enlarged bank loan demands from business, increased new corporate capital issues, and seasonal but nevertheless important Federal Government financings--both Treasury and agency issues--then demand would continue to outstrip available supplies and interest rates would continue upward. Bank lending would be under severe restraint, and use of nondeposit sources and Euro-dollars might be pursued more vigorously. There was also a possibility that sizable sales of securities might develop to meet the need for lendable funds.

As Mr. Coldwell viewed those matters, the Committee's continuing problem was to restrain credit demands to encourage a slower rate of economic advance. Certainly, any credit policy relaxation would instantly regenerate expansive plans and accentuate the expectations of inflation. A status quo policy had great appeal, for it might provide time for a better view of the results of the competing forces, but it would in effect be a slow easing as the Federal Reserve replaced the reserves used by the commercial banking system. A more restrictive open market policy would force more banks into restraining efforts or force greater efforts toward evasion.

In general, Mr. Coldwell remarked, he agreed with Mr. Sherrill's analysis. However, a modestly more restrictive policy would serve notice that the central bank was not satisfied with the rate of progress toward economic stability. Since he could not see a present net advantage to a discount rate increase, he had to seek other methods to reach the more important matter of credit availability. It was for that reason that he recommended that the Committee seek slightly firmer conditions in the money and credit markets, with any errors on the side of restraint. The set of conditions he favored would include Federal funds rates in the range of 9 to 9-3/4 per cent, net borrowed reserves ranging from $1.1 billion to $1.3 billion, and a short-term Treasury bill yield of 6-7/8 to 7-1/2 per cent.

Mr. Coldwell said he favored the changes in the draft directive suggested by Messrs. Treiber and Swan. The Committee might want to consider a further change in the first sentence, to indicate that the continuation of the expansion at the first-quarter pace was contrary to prior expectations. While he would not strongly press that suggestion for the directive, he did want to indicate his concern with the fact that over recent quarters the staff had repeatedly found it necessary to revise upward their initial projections of growth in GNP. He thought the Committee would have to focus primarily on what had actually been accomplished if it were to get the situation under control.

Mr. Morris said he would favor maintaining the System's existing degree of financial restraint. Some headway was beginning to be made in the area of business psychology. The pronounced weakness in the stock market was the best evidence that the views of a great many people in the business community were being affected. However, any marked headway in slowing the pace of the economy was yet to be made. Until such time as there was a pronounced and widespread decline in the leading indicators--and that had not yet occurred--he thought the Federal Reserve could not afford to relax policy.

Having said that, Mr. Morris continued, he would add that he opposed the draft directive on the ground that, in his judgment, it would lead to an intensification of restraint. A given monetary policy posture, when adhered to for very long, tended to generate its own momentum. As a consequence, the actual policy results could turn out to be more expansionary or more restrictive than intended. Last autumn the staff's projections of the financial aggregates had fairly consistently turned out to be on the low side. They were continually revised upward, and the System's policy was more expansionary than had been contemplated.

In June and July, Mr. Morris remarked, the opposite pattern was developing. There had been a quite general tendency during the past two months for the projections of aggregates to be revised downward. All of the July projections were now substantially lower than the estimates of three weeks ago. He thought that was a signal that policy was becoming more restrictive than had been contemplated.

Mr. Morris said he had felt that the Committee's policy was essentially correct during the past five months for four reasons: First, the persistent buoyancy of the economy. Second, the fact that the Committee's policy, at least through May, had produced a leveling off of bank credit but not a contraction. Third, the fact that, until very recently, disintermediation had been confined to the large commercial banks, which were well equipped to deal with the pressure. And fourth, the fact that the primary securities markets had continued to function remarkably well--which was, in part, a tribute to their 1966 training.

Two of those four conditions had now changed, Mr. Morris observed. The Committee was now seemingly embarked on a policy which was resulting in contraction of bank reserves and bank assets. Reserves were contracting despite the fact that the banks were continuing to acquire Euro-dollars on a very large scale. If the Committee's policy continued to produce a contraction in bank assets, he believed that the primary securities markets would deteriorate rapidly. The attempts of the banks to meet their problems by searching out nondeposit liabilities only tended to add to the pressures in other markets. In his judgment, when bank reserves were contracting at the rate of June and July a severely restrictive policy was in force, regardless of the success that the banks might be having in drawing nondeposit funds from other markets.

The second major change, Mr. Morris continued, was the fact that disintermediation was now spreading rapidly to smaller banks and to the nonbank intermediaries. That was leading to a very sharp contraction in the availability of mortgage credit and would soon lead, he believed, to a more serious contraction in housing starts than the staff had projected.

Mr. Morris felt that the Committee was drifting into a much more restrictive policy than most of the members had been talking about around the table. The monetary climate today was substantially more restrictive than three weeks ago no matter how it was measured. Yet there were few Committee members who had argued three weeks ago for a substantially more restrictive climate.

Mr. Morris thought there was a need to modify the directive along the lines proposed by Mr. Axilrod. He would also suggest that the proviso clause for the coming period should be one-way, operative only on the downward side. And he would restore to the proviso the language which the staff proposed be deleted, calling for operations to be modified "if unusual liquidity pressures should develop." It seemed to him that the probability that unusual liquidity pressures would develop was as high or higher now than at the last meeting. He shared Mr. Maisel's concern about the adjustment of the proxy to reflect nondeposit sources of funds. On both theoretical and practical grounds, he questioned whether those should be added to bank credit on a one-for-one basis.

Mr. Robertson made the following statement:

> We have come to the point, and have been there for several weeks, I believe, where our policies are having a real bite. This appears to be true whether one gauges policy by reserves, money supply, bank credit, interest rates, or what have you. More

significantly, it also appears to be true with respect to the most important gauge of policy--the effect of financial market conditions and flows on real economic activity. It would be surprising if construction outlays and business spending did not show a significant slowing over the next several months.

With our policies having become effective, the next question is how long we should maintain the present degree of firmness. I realize that over the past few months we have in some ways become even tighter than might have been contemplated. Both the money supply and total member bank deposits, for example, turned out to be weaker by the time the second quarter was over than they gave promise of being earlier. Still, from my point of view, this was desirable in light of the fact that our efforts to combat inflationary expectations were partly mitigated by the sharp rise in Euro-dollar borrowings and increased use of commercial paper issued by one-bank holding companies, subsidiaries, and affiliates of banks.

However, recognizing that tight conditions have now come into being, I think we should be very careful neither to prematurely relinquish the benefits of the present policy nor to press even further in our operations. To this end I would support removal of the word "firm" from the second paragraph of the directive, and go with the more neutral expression "currently prevailing". I agree with the suggestions of Mr. Treiber and Mr. Swan concerning the language of the first paragraph.

Chairman Martin observed that there had been expressions of sentiment in the go-around today for shading monetary policy in both directions, with perhaps a slight preponderance of those favoring some change inclined toward greater rather than less restraint. His personal view was that policy should be kept about unchanged. That was partly because the Treasury would be engaging in a refunding in the coming period, but more generally he did not favor trying to engage in fine-tuning to the degree to which some apparently were inclined, particularly since such critical events as wage settlements were beyond the reach of monetary policy. He did not agree with those, such as Professor Friedman, who argued that it was necessary only for the System to pull the right levers to do an effective job of economic stabilization. There were important limits on what could be accomplished through monetary policy.

The Chairman went on to say that he was deeply concerned about the outlook for the surtax extension bill; in his judgment there was a real possibility that it would not be enacted. In view of that uncertainty, he thought the Committee should call for holding as closely as feasible to the present degree of pressure. Perhaps the type of shading Mr. Axilrod had suggested would be acceptable as a technical matter, but he would not favor it because of the risk that it would be interpreted as a more significant move toward ease than would be intended. Inflationary psychology remained the main economic problem, although indications were beginning to appear that the business community was becoming aware of the seriousness of the situation. It would be a mistake, in his opinion, to take any action that might reinforce inflationary expectations just at the time when some weakening in those expectations might be developing. The System had been overly hasty in moving toward ease in the summer of 1968, in part because of faulty judgments but also because of faulty projections. He thought that no one could make projections with assurance at the moment.

As to the comments that had been made today regarding inadvertent firming, the Chairman continued, he believed it was inherent in the nature of the Trading Desk's operations that conditions could change as a result of market forces. In that connection he would note that if the decision were his alone he would dispense with the kind of analysis presented in the blue book.

Chairman Martin then observed that a number of modifications had been proposed in the staff's draft of the directive. As he had indicated on other occasions, he thought that it was not feasible for a group as large as the Committee to act as a drafting body, and that it was not useful to make extensive revisions in the staff's draft if it was generally acceptable, as he felt was the case today. However, the changes proposed by Messrs. Treiber and Swan were moderate, and he personally would have no objection to them.

Mr. Partee remarked that there was a technical problem with Mr. Treiber's proposed statement reading "In June there was little change in bank credit." The problem arose because use by banks of important nondeposit sources of funds was not reflected on their balance sheets and hence was not recorded as bank credit. If the Committee wanted to accomplish the purpose underlying

Mr. Treiber's proposal it might be better to use some such language as the following: "In June bank credit showed little change, after allowance for assets sold to affiliates and to customers with bank guarantees."

Mr. Treiber indicated that Mr. Partee's formulation was acceptable to him.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft with the word "further" deleted from the first sentence, with the statement on bank credit as formulated by Mr. Partee, and with Mr. Treiber's proposed revision of the statement on the balance of payments.

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, after moderating slightly in the first quarter, has continued at about the same pace since then. Substantial upward pressures on prices and costs are persisting. Market interest rates have fluctuated widely recently, partly because of varying expectations, although credit demands remain relatively strong. Short-term rates on balance have continued under upward pressure, against the background of considerable restraint on the banking system. In June bank credit showed little change, after allowance for assets sold to affiliates and to customers with bank guarantees. Growth in the money supply resumed at a slow pace, and the run-off of large-denomination CD's which began in mid-December continued without abatement. There apparently were substantial net outflows from consumer-type time and savings accounts at banks and nonbank thrift institutions around midyear, following a period of slackened growth. The over-all balance of payments deficit on the liquidity basis rose sharply in the second quarter; there were large outflows into German marks and into Euro-dollar deposits, and there was no significant improvement in net exports. In contrast, there was another large surplus on the official settlements basis as U.S. banks borrowed heavily in the Euro-dollar market. 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, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the currently prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury refunding, if bank credit appears to be deviating significantly from current projections.

Chairman Martin then suggested that the Committee continue its discussion of possible outright System transactions in Federal agency issues. He noted that one consideration that had been raised in the discussion at the previous meeting was the timing of the Congressional hearings on extension of the legislation authorizing the operations in question. Contrary to earlier expectations, it now appeared that those hearings would not be held before Labor Day. It had also been suggested that the views of the Treasury should be ascertained, although, of course, the decision was for the Committee and not the Treasury to make. He could report from conversations with the Secretary of the Treasury that Mr. Kennedy had serious reservations about the desirability of the System's undertaking outright operations in agency issues, and that he thought the present was a particularly poor time to begin such operations.

While he gave a great deal of weight to the Secretary's views, Chairman Martin continued, he had independently arrived at the conclusion that the Committee should postpone consideration of the matter. Mr. Holmes had indicated in his memorandum of June 20, 1969[1/], that the volume of financing by Federal agencies would increase substantially in fiscal 1970, with the number of individual issues proliferating. From conversations with the Budget Bureau, he (Chairman Martin) had the impression that the proliferation of issues might be even greater than Mr. Holmes' memorandum suggested.

Mr. Robertson said he would note for the record that he was still of the view that the System should move ahead at this point with experimental outright operations in agency issues. He agreed that there was merit in the argument that it was desirable to wait to see whether the Treasury would be able to accomplish

1/ A copy of this memorandum, entitled "Considerations against Federal Reserve operations in agency issues at this time," has been placed in the Committee's files.

some consolidation of such issues. However, he thought the System would be wasting time by not undertaking experimentation now. Moreover, he was of the opinion that the Federal Reserve was more likely to find itself in a difficult situation if it did not undertake operations now than if it did. Such questions were, of course, matters of judgment and judgments could differ.

Mr. Daane said he would support the Chairman's position. He thought it was desirable to give the Administration time to reach a decision with regard to consolidating agency issues, while the Committee kept an open mind on the question of whether to undertake outright operations.

Mr. Brimmer remarked that Mr. Daane's comment implied a longer postponement of a Committee decision than he had understood the Chairman was proposing. Given the various kinds of pressure on the Administration he did not think much progress would be made on the matter of consolidation of issues before the System was called upon to testify at the Congressional hearings. Accordingly, the System was likely to be in a position at the time of those hearings of not having used the discretionary authority granted by statute. When the matter was held over at the Committee's previous meeting he had hoped that a decision would be reached today, or at least at the meeting in mid-August. If the proposal were now to postpone a decision indefinitely, or until the Treasury accomplished some consolidation of agency issues, he could not support it.

Chairman Martin remarked that he had been careful to avoid any implication that the decision was for the Treasury to make. And while, as he had indicated earlier, he gave much weight to the Secretary's opinion, the Committee members should feel free to make whatever decision they thought proper. As Mr. Robertson had suggested, a matter of judgment was involved. After talking about the subject with a number of people, he (Chairman Martin) had arrived at the conclusion that it would not be helpful for the System to undertake outright operations in agency issues at this time.

Chairman Martin then proposed that the matter be held over until the next meeting of the Committee, and there was general agreement with the Chairman's proposal.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 12, 1969, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida

Deputy Secretary

ATTACHMENT A

CONFIDENTIAL (FR) July 14, 1969

Draft of current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on July 15, 1969

The information reviewed at this meeting suggests that expansion in real economic activity, after moderating slightly further in the first quarter, has continued at about the same pace since then. Substantial upward pressures on prices and costs are persisting. Market interest rates have fluctuated widely recently, partly because of varying expectations, although credit demands remain relatively strong. Short-term rates on balance have continued under upward pressure, against the background of considerable restraint on the banking system. In June bank credit declined further on average, growth in the money supply resumed at a slow pace, and the run-off of large-denomination CD's which began in mid-December continued without abatement. There apparently were substantial net outflows from consumer-type time and savings accounts at banks and nonbank thrift institutions around midyear, following a period of slackened growth. Despite lack of significant improvement in net exports, there was another large surplus in the balance of payments on the official settlements basis in the second quarter, as heavy Euro-dollar borrowing by U.S. banks more than offset net outflows in other capital transactions. Large outflows into German marks and into Euro-dollar deposits swelled the over-all deficit on the liquidity basis. 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, while taking account of the forthcoming Treasury refunding, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the currently prevailing firm conditions in money and short-term credit markets; provided, however, that operations shall be modified, to the extent permitted by the Treasury refunding, if bank credit appears to be deviating significantly from current projections.