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, December 17, 1968, at 9:30 a.m.

PRESENT: Mr. Hayes, Vice Chairman, Presiding
Mr. Brimmer
Mr. Daane
Mr. Galusha
Mr. Hickman
Mr. Kimbrel
Mr. Maisel
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Bopp, Clay, Coldwell, and Scanlon, Alternate Members of the Federal Open Market Committee

Messrs. Heflin, Francis, and Swan, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively

Mr. Holland, Secretary
Mr. Sherman, Assistant Secretary
Mr. Kenyon, Assistant Secretary
Mr. Broida, Assistant Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Brill, Economist
Messrs. Axilrod, Hersey, Kareken, Mann, Partee, Reynolds, Solomon, and Taylor, Associate Economists
Mr. Holmes, 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. Keir, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Bernard, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Mr. Lewis, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Eisenmenger, MacLaury, Eastburn, Jones, Tow, Green, and Craven, Vice Presidents of the Federal Reserve Banks of Boston, New York, Philadelphia, St. Louis, Kansas City, Dallas, and San Francisco, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Messrs. Wallace and Scheld, Assistant Vice Presidents of the Federal Reserve Banks of Richmond and Chicago, respectively
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

Mr. Hayes called on Mr. Robertson, who said he would like to advise the Committee in advance of today's open market policy discussion of the status of two other Federal Reserve policy issues that were being considered by the Board of Governors. The Board now had pending before it discount rate actions by eleven Reserve Banks,

of which two involved no change in the existing 5-1/4 per cent rate, seven involved an increase of 1/4 percentage point to 5-1/2 per cent, and two involved an increase of 1/2 percentage point to 5-3/4 per cent. The Board's tentative thinking was to approve the 1/4 percentage point increases while withholding action on the others until the directors of those Reserve Banks had had a chance to meet again following the Board's action, but a final decision was being held in abeyance.

In addition, Mr. Robertson continued, the Board was considering a proposal to buttress the discount rate rise with the simultaneous announcement of an increase in member bank reserve requirements on demand or time deposits, to take effect in the week beginning January 16, 1969. That action would be tailored to absorb between $450 and $650 million of the seasonal return flow of reserves. If that were done, open market activities should, of course, avoid washing out that tightening of reserve positions.

Mr. Robertson went on to say that the Board recognized, as he was sure everyone else did, that the discount rate increase had already been well discounted by the money market. A combination of discount rate and reserve requirement increases would represent overt action with significant announcement effect, sufficient to have a salutary dampening impact on inflationary expectations.

However, it was necessary to weigh the pros and cons of such an announcement effect--from both the domestic and the international standpoints.

Mr. Robertson indicated that the Board had decided to hold off action on those matters until after this morning's Federal Open Market Committee meeting, in order to provide for the maximum possible coordination of the System's policy instruments. Assuming all went well, the Board would expect to meet on the discount rates and reserve requirements some time later this afternoon, or perhaps tomorrow, and announce whatever action was decided upon.

Mr. Robertson then noted that the staff had prepared drafts, labeled alternatives "A" and "B," of a current economic policy directive for the Committee's consideration.[1/] He would offer a third alternative, labeled "C," which would provide in the second paragraph for coordination of open market policy with possible discount rate and reserve requirement actions. In his proposal the description of the Committee's general policy stance at the end of the first paragraph would be as shown in the staff's alternative B, except for a clarifying language change.

Specifically, Mr. Robertson said, alternative C would be the same as the staff's draft until the last sentence of the first paragraph. It would then continue as follows:

1/ The staff's drafts are appended to this memorandum as Attachment A.

In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining somewhat firmer conditions in money and short-term credit markets, taking account of the effects of other possible monetary policy action; provided, however, that operations shall be modified if bank credit expansion appears to be deviating significantly from current projections.

He wanted to put all this before the Committee at the outset this morning, Mr. Robertson observed, so that it could be taken fully into account in the discussion. He added that under the present lagged procedure for calculating required reserves, an increase in requirements effective January 16 would, of course, be related to deposits held in the week beginning January 2.

Mr. Hayes commented that it was very helpful to the Committee to have heard Mr. Robertson's remarks before the go-around on open market policy.

Mr. Daane observed that it might be desirable to underscore the point that the matters to which Mr. Robertson had referred were still under consideration by the Board and that no action had been taken.

Mr. Brimmer agreed that it was not possible at this point to anticipate the actions the Board might take. It was his impression, however, that members of the Board were in agreement on the desirability of a discount rate increase, and that the question remaining open concerned the desirability of increasing reserve requirements as well.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on November 26, 1968, were approved.

Mr. Daane asked whether there would be any objection to a small clarifying revision, which he described, in the memorandum of discussion for the meeting held on November 26. There was general agreement that the indicated revision should be made.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on November 26, 1968, 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 November 26 through December 11, 1968, and a supplemental report covering the period December 12 through 16, 1968. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. MacLaury said there would be no change in the Treasury gold stock this week. Moreover, since the Stabilization Fund now held $536 million, there should be no need for any reduction in Treasury gold for the foreseeable future.

So far as the gold markets were concerned, Mr. MacLaury continued, the calm that had prevailed even during the most severe days of the currency crisis in November had continued, with the somewhat higher prices apparently reflecting the fact that South Africa, after having sold gold in November, had dropped out of the market again for the time being. Although South Africa still faced a major problem in marketing its output, it should be noted that reserve figures for the last few weeks indicated that the South African payments position had again moved into surplus, permitting them to stockpile production for the time being.

Mr. MacLaury observed that when Mr. Coombs reported to the Committee at its previous meeting he had just returned from the Bonn meetings and was still waiting to see how the markets would react to the German and French decisions not to change their parities. A little over three weeks had now gone by, and he (Mr. MacLaury) thought it was fair to say that the German measures had been successful in the short run, at least in reversing the

sizable inflows that had built up so strongly in November. Nearly $900 million had left Germany in the last week of November. Although the outflow since then had been erratic--and, indeed, had been reversed temporarily on December 5 when the report of the German Council of Economic Experts seemed to suggest that a mark revaluation still lay ahead--on balance funds had continued to move out in size this month, partly on the basis of market swaps by the German Federal Bank. Thus far in December the gross outflow from Germany had been on the order of $1.5 billion. The net outflow was considerably less--about $600 million--because maturing forward contracts the Federal Bank had made in September were falling due.

As the Committee would recall, Mr. MacLaury continued, the German authorities had agreed that it would be desirable to offer outright forward cover into German marks both in Frankfurt and in New York when the markets reopened following the Bonn meetings. In view of the great uncertainties that were bound to be present, that initiative was highly desirable, both as a confirmation to the market that a revaluation of the mark was out of the question for the time being and as an inducement to start funds actually moving out of Germany. During the five trading days of the last week in November, when the Federal Bank was offering outright forward marks at a 3 per cent premium, it sold a total of $236 million equivalent; while the Federal Reserve, in parallel operations, sold a total of $72.5 million in New York.

The bulk of that business was done in the early days of the last week of November, Mr. MacLaury noted. As the week progressed, not only did the demand for outright forward cover seem to taper off, but the German Federal Bank also became concerned that its offer of outright forward cover would provide a means by which foreigners speculating on a mark revaluation could, in effect, remain in marks without foregoing interest as was designed to be the case for those who held on to mark deposits. In other words, the German authorities felt that the offer involved a potential conflict of policy objectives. Accordingly, beginning in December the Federal Bank withdrew its offer of outright forwards, in the belief that the main purpose of the offer had been accomplished and that it could be reinstituted if market developments called for such action. Instead, the Federal Bank offered a more attractive rate--2-3/4 per cent--on swaps with German commercial banks. The Federal Bank sold dollars spot and bought them back forward, with the provision that the banks themselves undertake foreign investments for the same maturity as the maturity of the swap. The technicalities of those operations were rather complex, and an additional complexity was added by the agreement to share with the German Federal Bank the profits on outright forward operations undertaken by the Federal Reserve in New York. However, he had no doubts concerning the usefulness of that forceful but temporary operation under the market conditions then prevailing.

In that connection, Mr. MacLaury said, he should mention that the Special Manager had not overlooked the Committee's request at its previous meeting for a memorandum on the possible need to enlarge the authority for System forward operations. When Mr. Coombs mentioned that subject three weeks ago, there had been a real possibility that forward operations in marks could expand rapidly to absorb the existing authority. That turned out not to be the case; as he had indicated, the System's total sales of forward marks had come to only $72.5 million. Therefore, since there was still considerable leeway under the $550 million limit specified in the Committee's present authorization, it was felt preferable to delay the memorandum until the need for a higher limit was clearer. Obviously, he could not rule out the possibility that developments in the market might force the Special Manager to request expanded authority to undertake forward operations, perhaps under emergency circumstances. But every effort would be made to give the Committee adequate time to consider such a request by circulating a memorandum on the subject in advance.

As he had already indicated, Mr. MacLaury continued, a sizable net amount of dollars had moved out of Germany in the last few weeks. By and large, however, those funds had not gone back into sterling or French francs. Sterling in particular had had a rocky time since the Bonn meeting. It was hard to say exactly why

sterling should have continued to look as sick as it had in much of the recent period, given the measures announced by Chancellor Jenkins. Clearly, one underlying factor had been the persisting uncertainties that had plagued the exchange markets since the Bonn meeting, at which nothing had really been settled. Equally important, confidence in the Labor Government was at such a low ebb that it was almost taken for granted that any measures announced would somehow go awry. He thought that overblown expectations concerning the Basle discussions of recycling of speculative funds also had had a temporary backlash effect on sterling, while the renewed although transitory speculation in the mark a week and a half ago was, understandably, unsettling. At the same time, there were rumors of dissension within the British cabinet and even rumors that Prime Minister Wilson might resign.

Mr. MacLaury noted that the cost to the Bank of England of support for sterling in the four trading days starting December 5 amounted to more than $350 million, not counting another $100 million of support in the forward market in that period. Those losses were offset to a considerable extent last Wednesday and Thursday (December 11-12) by inflows resulting from short covering and buying in anticipation of good figures on British foreign trade in November. But the fact remained that the Bank of England had had to increase its swap drawings on the System by $750 million since

the beginning of November, bringing the total of such drawings to $1,150 million and the aggregate of Britain's short-term debts once more to over $3 billion. It hardly had to be said that there was very little evidence as yet of any reversal in Britain's fortunes. Under such circumstances it was not surprising that counsels of despair were being heard again, and that sterling remained in a precarious state.

By contrast, Mr. MacLaury continued, the harsh French measures in the area of exchange controls had apparently had their desired effect, at least in the short run. By requiring French commercial banks to unwind--in effect, to break--outstanding forward contracts with their customers and to turn over to the Bank of France the spot foreign exchange held as cover for those contracts, the authorities had given a one-shot boost to official reserves amounting to several hundred million dollars in the last ten days. It remained to be seen whether such measures would be successful in the longer run. For the time being, however, the franc was off the floor and the French had been able to reduce their short-term debts, including their swap drawings on the System which were down from a peak of $611 million to a present level of $490 million.

Trading in most other currencies had been uneventful, Mr. MacLaury observed, although local money market pressures in Switzerland and the Netherlands had tended to strengthen rates for

the respective currencies. He should mention, however, the Euro-dollar market where normal year-end patterns had been distorted by the huge movements of funds into and out of Germany. On balance, although rates had risen during the past three weeks by about 1/4 percentage point on most maturities, there had been only occasional stringencies in the market. As a result, the Bank for International Settlements had put only $80 million into the Euro-dollar market on the basis of drawings on the Federal Reserve, compared with some $350 million over the year-end last year.

Mr. Galusha asked whether Mr. MacLaury would comment on the possible implications for sterling of an overt change in U.S. monetary policy.

In reply, Mr. MacLaury noted that he had described the present position of sterling as precarious. While he could not say precisely how precarious the situation was, he thought there clearly would be some risk for sterling in U.S. monetary action. On the basis of the information available to him he doubted that limited action--involving, say, a small increase in the Federal Reserve discount rate--would prove to be the final straw for the pound. More vigorous action would entail greater risks, but he was unable to assess them with any confidence.

Mr. Mitchell asked whether technical considerations taken alone suggested that sterling would prove vulnerable to a change in the discount rate.

Mr. MacLaury replied in the negative. He noted that--given the present discount on forward sterling--the relationships between market interest rates in Britain and, say, in the Euro-dollar market were such as to provide no incentive for covered flows of funds to the United Kingdom. Britain's disadvantage in such comparisons was so large that the small further disadvantage that would result from an increase in the U.S. discount rate was not likely to have a significant technical effect. The more important question, he thought, would involve possible psychological effects.

Mr. Mitchell then asked whether U.S. monetary action taken for domestic reasons was likely to have a significantly adverse psychological effect on sterling.

Mr. MacLaury responded that, in the longer run, actions to strengthen the dollar obviously were in the best interests of sterling and of the general international payments mechanism. But considerations of timing were very important. Even before the November exchange crisis the British had felt that their short-term debts were about as high as they could justify, and since then they had had to borrow an additional $750 million.

Clearly, there was a risk that the point was near at which the British would decide that they were not prepared to take on any further debt; and such a decision obviously would have important implications for the dollar. He could not say whether any particular actions by the System would bring them to that point.

Mr. Robertson remarked that on the basis of some international telephone conversations he had held this morning he had concluded that a 1/4 point increase in the discount rate would not cause concern, but that a larger discount rate increase would cause serious concern. Additional action in the form of some firming of open market policy and an increase in reserve requirements might cause some concern, but not of a serious nature since the amount of tightening involved probably had already been largely discounted.

Mr. Daane noted that there had been some recent discussions within the U.S. Government of the degree of precariousness of the sterling situation, following the receipt of certain advice from Under Secretary Deming who was in London. Mr. Deming had described the general attitude prevailing in the British financial community in terms that suggested the desirability of exercising some caution in U.S. monetary policy actions. However, from the Under Secretary's comments it seemed clear that a 1/4 point increase in the Federal Reserve discount rate was not expected to cause any serious disturbance to sterling.

Mr. Daane added that the information Mr. Robertson had received this morning obviously was more current than that which Mr. Deming had transmitted earlier. But he (Mr. Daane) was somewhat puzzled by the report that additional Federal Reserve action, such as an increase in reserve requirements, would not be a source of serious concern. As Mr. MacLaury had pointed out, the question was not simply one of technical relationships; account also had to be taken of the possible effects on market psychology, which were largely unpredictable. There might also be effects on the internal political situation in Britain that would have consequences for governmental decisions.

Mr. Hayes said that on the basis of recent discussions he also had the impression that a small increase in the Federal Reserve discount rate would not have serious consequences for sterling. The possible implications of more overt action were extremely difficult to evaluate. He understood that Mr. Solomon would comment on the subject in his remarks later in the meeting, and members of the Committee presumably would give their views in the course of the go-around.

Mr. Maisel then said that he would like to comment on another matter. Increasingly in recent months, because he had been unable to understand how individual actions were expected to aid in achieving either the Committee's short- or long-term goals,

he had been concerned as the System's foreign operations and commitments had expanded. His unease had increased during the past period when the System seemed to be conducting foreign and domestic operations with opposing goals. Domestically, the System was fighting to slow down reserve expansion and to hold up short-term rates as an aid in reducing inflationary pressures. Through System swaps with the BIS it was increasing reserves and was striving to ease Euro-dollar rates, which had the effect of maintaining or increasing the availability of credit in U.S. domestic markets.

While he recognized that opposite short-term actions might be completely logical, Mr. Maisel continued, a careful review of past reports and analysis of such swaps showed no indication that the Committee had considered their domestic implications, nor was there any measure or much discussion of what cost-benefits the Committee expected from its actions. It had given a broad delegation of powers to the Special Manager to operate so as to aid in avoiding disorderly exchange markets. It did not seem to have asked him to consider the impacts of his acts on domestic policy objectives. It had not asked him to consult with the Committee when taking actions nor had it requested him to report his analysis of the impact of those actions. The Committee appeared to have been operating with a minimal analytical model and decision-making

process, particularly when comparison was made with the detailed examination and daily concern evidenced in the domestic sphere.

Similarly, Mr. Maisel said, today he would not feel as uncomfortable as he did about having voted to commit over $6 billion of the System's resources if he were clearer in his mind as to what theory supported their use. As he had participated in meetings of the Committee, it had seemed to him that there had been several different implicit assumptions as to why particular loans were or were not made. Yet each had been justified in most general terms as meeting the Committee's foreign currency directive. Even though he had been on the Committee as long as half the members, he could recall few, if any, discussions at meetings of the logic of any particular operations similar to the discussions in the domestic sphere.

In conclusion, Mr. Maisel said he had to admit that having reviewed the generalness of the Committee's instructions to the Special Manager, he felt most uncomfortable over what now appeared to him to have been a neglect of his responsibility in the matter. He wondered whether other members of the Committee had the same feeling. The fact that the Committee had authorized potentially conflicting operations worried him, as did the magnitude of the System's commitments. He would hope that in the future the Committee might be able to get a better analysis in its reports of

both the immediate and the ultimate objectives of specific operations so that it could make the necessary judgment as to whether or not it was fulfilling its responsibilities.

Mr. Hayes said it would be desirable to have comments from both Mr. MacLaury and Mr. Holmes on the subject Mr. Maisel had discussed.

Mr. MacLaury observed that the Account Management had been highly cognizant of the problem of conflict between foreign and domestic operations--not only potential but actual conflict. The potential for conflict was implicit in the very existence of the System's swap network, since drawings and repayments had consequences for bank reserves and the money market. Staff working in the foreign area were in continual contact with Mr. Holmes, consulting about operations day by day and when necessary hour by hour. On the basis of such consultations, for example, arrangements recently had been made with some of the System's swap partners to invest their dollar inflows or proceeds of drawings in a manner designed to create as few problems as possible for domestic operations.

Mr. MacLaury noted that Mr. Maisel had referred specifically to the recent BIS operations in the Euro-dollar market financed by drawings on the System. The BIS undertook such operations only with the Special Manager's concurrence so the associated swap

drawings could be closely controlled by the System. Recently, for example, because of the problem of conflict the BIS had been told to limit its placements in the Euro-dollar market financed by drawings on the Federal Reserve to the minimum consistent with the maintenance of orderly conditions, and in any case not to exceed $150 million. In accordance with those instructions the BIS had placed only $80 million in the market, far less than it might otherwise have done.

Mr. Holmes said he could confirm Mr. MacLaury's statement about the close relationship maintained between the staffs concerned with domestic and foreign operations. Foreign operations obviously were a matter of importance to the domestic staff since they affected reserves and sometimes led to complications, but on the whole he thought the two staffs had worked together well.

Mr. Maisel remarked that he was not questioning the adequacy of coordination in day-to-day operations. Rather, he was raising the much broader problem of conflicts in objectives, which he thought was illustrated well by the recent operations aimed at easing the Euro-dollar market. Those operations had the effect of keeping funds in the United States that otherwise would have gone back to the Euro-dollar market. They might also have fostered the belief that the System was prepared to act as the lender of last resort in the Euro-dollar market, and consequently might have

led U.S. banks to borrow a much larger amount of Euro-dollars than they would have otherwise. The question of whether such operations were desirable was likely to become increasingly important if firming actions by the System put greater pressure on the Regulation Q ceilings, since the volume of U.S. bank borrowing in the Euro-dollar market would then become critical.

Mr. Hayes said he thought Mr. Maisel had raised an interesting point, and he agreed that there was some degree of conflict in the objectives of such foreign operations and domestic operations. At the same time, the scale on which the BIS had put funds into the Euro-dollar market recently was small; and he thought the ends served were sufficiently important to outweigh any incidental disadvantages from the domestic point of view. In any case, the effects on domestic financial markets could be offset readily by open market operations.

Mr. MacLaury observed that at the time of the last BIS meeting Mr. Coombs had advised the group of gold and foreign exchange experts that, while the System was prepared to put some funds into the Euro-dollar market, such operations obviously might conflict with U.S. domestic objectives. Accordingly, he had asked that other central banks stand ready to place funds in the market, either in conjunction with the Federal Reserve operations or in lieu of them. With respect to one of Mr. Maisel's comments, he

questioned whether the System's posture could be described appropriately as that of a "lender of last resort" to the Euro-dollar market. That description would fit a lender who left the initiative to the borrower; in the present case, the System made the decisions on when it was desirable to give assistance to the Euro-dollar market. He had heard some comment in the New York financial market to the effect that the Federal Reserve was putting back with one hand what it was taking with the other, but he did not believe that such an assessment was accurate.

Mr. Mitchell remarked that he was a little disturbed by the suggestion in earlier comments by Mr. Holmes that the Desk had not been able to offset fully the impact of international transactions on the domestic money market.

Mr. Holmes said that, by and large, it had been possible to offset the impact of international transactions, although on occasions when the flows had been very heavy it had taken a few days to do so. Insofar as there were problems, they were matters of fine tuning which on the whole were not serious.

Mr. Hickman recalled that the Desk had experienced problems a few weeks ago in connection with investments of dollars that were flowing into Germany, some of which originated in drawings on the System's swap lines. Both those transactions and their subsequent reversal had had some rate effects despite the Manager's best efforts to avoid them.

Mr. Hickman added that he was concerned not only about the implications of the operations in the Euro-dollar market but about the general problem posed by the fact that System foreign currency operations were creating a large volume of dollars at a time when domestic considerations argued for restraint.

Mr. Brimmer said he was inclined to share the views Mr. Maisel had expressed. It seemed to him that there typically was less advance consultation with the Committee in connection with major operations in the foreign currency area than on the domestic side. Of course, it was not always possible to anticipate the kinds of foreign operations that would be required in the period before the next meeting of the Committee. But that did not seem to be the whole explanation for the present situation. For example, at the November 26 meeting the Special Manager might well have commented on the matter of possible operations in the Euro-dollar market.

Mr. Brimmer noted that the Committee followed the practice of reviewing its foreign currency directive annually, at the March organization meeting, and rarely considered it at other meetings. Perhaps it would be desirable to undertake such reviews on a somewhat more frequent basis. The staff might be asked to look into the pros and cons of such a procedure.

Mr. Hayes remarked that it was clearly useful for the Special Manager to report to the Committee on possible operations,

to the extent that he could foresee major flows likely to call for particular operations. For the most part, he thought the Special Manager did what he could in that connection. However, it seemed to him (Mr. Hayes) that the occasions on which one could see very far ahead in the foreign currency area were few. He recalled that at the Committee meeting in late October, only a few weeks before the major crisis of November emerged, the thrust of the discussion was that conditions in foreign exchange markets were tranquil.

Nevertheless, Mr. Hayes continued, he thought the subject was worth pursuing. He would suggest that the staff, including the Manager and Special Manager, look into it and prepare a memorandum that the Committee could consider in due course. In the meantime, he was sure the matter would be kept in mind by both Managers.

There was general agreement with Mr. Hayes' suggestion.

> By unanimous vote, the System open market transactions in foreign currencies during the period November 26 through December 16, 1968, were approved, ratified, and confirmed.

In response to Mr. Hayes' request for his recommendations, Mr. MacLaury reported that five drawings by the Belgian National Bank, totaling $45.5 million, would mature for the first time in the period from December 20, 1968, to January 10, 1969. He

anticipated that most if not all of those drawings would be paid off by year-end, since the Treasury was expected to purchase $60 million of Belgian francs in connection with the planned reconstitution of the U.S. gold tranche position in the International Monetary Fund. If any of those drawings were still outstanding at their maturity dates, however, he would recommend their renewal.

Renewal of the five drawings by the Belgian National Bank was noted without objection.

Mr. MacLaury noted that a $200 million drawing by the Bank of England would reach the end of its second three-month term on January 2, 1969. He would recommend renewal of that drawing if, as he expected, the Bank of England so requested.

Renewal of the $200 million drawing by the Bank of England was noted without objection.

Mr. Hayes then asked Mr. Solomon to report on developments at the recent meeting of Working Party 3 that the latter had attended.

Mr. Solomon said that in the interest of saving time he would summarize the statement he had prepared and submit the full statement for inclusion in the record. He then summarized the following statement:

Working Party 3 met in Paris last week and, naturally, focused on the three countries--Germany,

France, and Britain--that were most affected by the intense currency speculation of November.

It was pointed out at the outset of the meeting that the basic payments positions of these three countries in the period just before the crisis seemed to be improving rather than worsening. The United Kingdom had an over-all balance of payments surplus in the third quarter--temporary though it may have been--and the over-all deficit in October was very small. France was in rough balance in October. And Germany was in small over-all deficit in October. This set of facts confirms the observation I put to this Committee three weeks ago: that the crisis had its origin in a belief by the market that the German Federal Bank would not be able to maintain the easy money policy that was making possible a massive capital outflow compensating the very large German trade surplus.

In any event, the crisis had occurred and measures had been taken by the three countries. The Working Party attempted to evaluate the effects of these measures.

The German authorities continue to believe that their 4 per cent border tax adjustment will reduce the trade surplus by about $1 billion. They also believe that the domestic expansion has sufficient dynamism so that additional fiscal measures will not be necessary to offset the $1 billion reduction in the trade surplus. But monetary policy in Germany can now continue as it was, whereas, in the absence of what Dr. Emminger called a "de facto revaluation" the German Federal Bank would have had to shift toward greater restraint for domestic reasons.

The French representative began his presentation by decrying the agitation for a conference to deal with international monetary reform, which, he said, only stimulated speculation. The French expect their own budgetary and credit measures plus the German measures to improve their basic balance of payments by about $1 billion in 1969. If capital flight subsides, this would leave the French in a comfortable payments position. In fact, if and when confidence is restored, the deflationary policies could probably be relaxed somewhat.

The big question is whether social and political unrest will arise before confidence in the currency has been restored.

The additional budgetary and credit measures adopted by the United Kingdom have been wrongly interpreted as still another dose of deflation for the British economy. The fact is that these new measures are intended only to put Britain back on the track that was foreseen at the time of devaluation. Both consumer expenditures and imports have been considerably higher than was planned a year ago and the balance of payments improvement has been correspondingly poorer. The major open question regarding the United Kingdom is its incomes policy--whether wage demand can be held in check.

The underlying balance of payments has been improving--and last month's trade deficit was the lowest in a long time. But despite this trend toward improvement, there remains a pall of deep skepticism in the exchange market. The good trade figures announced last week had very little market effect. The skepticism is based, no doubt, on political uncertainties in Britain as well as economic uncertainties. In these circumstances sterling continues to be vulnerable to shocks; witness the reaction to developments in the Middle East recently. It seems all too probable that another severe shock and an attendant large loss of reserves would push Britain to a floating exchange rate--with highly unpredictable effects on the international monetary system. Yet the underlying economic situation does not call for a lower exchange rate for the pound.

Under these conditions, the Federal Reserve must weigh the advantages of any announcement effect it seeks at home against the risks that a big announcement effect could knock sterling off its parity. An uptrend in interest rates in the U.S. and in the Euro-dollar market would not by itself hurt sterling, which is already at a 3 or 4 per cent disadvantage owing to the discount on forward sterling. The danger comes rather from a more generalized reaction by the market, perhaps irrationally, that an abrupt tightening of U.S. monetary policy would have financial and real effects greater than sterling can bear.

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 November 26 through December 11, 1968, and a supplemental report covering December 12 through 16, 1968. Copies of both reports have been placed in the files of the Committee.

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

> Since the Committee last met three weeks ago, the financial markets have undergone a psychological crunch much more severe than warranted by actual developments. There were really no sensational developments either at home or abroad to account for the deterioration of market psychology. Rather, it appeared that as business developments continued to reflect greater strength in the economy than had been anticipated earlier, fears of inflation were sharpened. The unexpected increase in the prime rate to the 6-1/2 per cent level prevailing earlier in the year tended to focus attention on the pressures existing in the economy and heightened expectations of a tightening of monetary policy. In addition to regular seasonal factors associated with the dividend and tax period, technical factors--such as the need for the System to absorb large amounts of reserves created by a sharp decline in the Treasury balance and an unexpectedly high level of float--and persistent sales of Treasury bills by foreign monetary authorities also added to market pressures on interest rates.
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> The net result was to produce a sharp upward thrust on interest rates in all maturity areas, bringing rates in most instances to levels above the peaks prevailing in May and June of this year. The three-month bill rate, for example, moved up by about 1/2 of a percentage point from the 5.46 per cent level prevailing at the time of the last meeting. In yesterday's regular Treasury bill auction average rates of 5.97 and 6.02 per cent, respectively, were set for three- and six-month bills, up 52 and 45 basis points from the auction just preceding the last meeting of the Committee.

The capital markets were equally hard hit, with U.S. Government securities feeling the competition of corporate yields that reached 7 per cent or more, while tax-exempt issues reached their highest yields since 1934. The capital markets were faced with a substantial volume of undigested new issues which had been offered late in November together with large blocks of tax-exempt industrial revenue bonds that were seeking to beat the January 1 deadline when newly-sold industrial revenue issues larger than $5 million will lose their tax-exemption privilege. There were a number of syndicate terminations during the period, while postponement or cancellation of new corporate and municipal issues amounted to about $360 million. By the close of the period it appeared that the sharply higher rate levels were beginning to attract investor interest and new issues were moving well.

The conduct of open market operations was a complicated and frustrating experience. As you know, midway in the period the credit proxy for December appeared to be showing a 9 per cent or more annual growth rate, above the 5 to 8 per cent range anticipated at the last meeting. This clearly called for implementation of the proviso clause. Treasury bill rates, however, were already 1/4 of a percentage point or more above the upper end of the range considered likely at the last meeting, and the market was considerably less than enthusiastic about absorbing the Treasury bills that we had to sell for foreign accounts. The Treasury's cash position also proved to be a millstone around the neck of open market operations. As you know, the Treasury had to borrow a modest amount directly from the System on two days last week and $430 million over the week-end. Thus, the Treasury, after taking account of a run-down of its normal balance with the Reserve Banks, has been supplying the market with almost $1-1/2 billion of reserves. Hong Kong flu also added unexpectedly to the supply of reserves as increased absences led to an increase in holdover float at the Reserve Banks.

Given this need to absorb reserves, and with the Treasury bill market in a tender state, extensive use was made of matched sale-purchase agreements with over

$3-1/2 billion of such agreements entered into during the period. The availability of this technique--rather than complete reliance on outright sales of bills--helped to avoid an undesirable further degree of pressure on Treasury bill rates and perhaps a disorderly market. I might add parenthetically that during the week ended December 11 outright sales of $280 million were made in the market and $290 million to foreign accounts. Even with this volume of reserve absorption, the Federal funds rate generally remained at 5-7/8 per cent. A rate of 6 per cent or above would have been more consistent with implementation of the proviso clause but the risks involved in pushing that hard appeared too great to undertake.

At the current level of rates, Treasury bills have become very competitive with bank CD's, so that, as the blue book[1/] notes, CD attrition in December is expected to be somewhat greater than seasonal. Major banks had, however, undertaken a precautionary build-up of CD's in November and excessive pressures are unlikely if bill rates tend to stabilize or edge lower and if Euro-dollars remain marginally available until the year-end and undergo the usual seasonal increase thereafter. The possibility of a significant squeeze on CD's cannot be ruled out, however, if banks aggressively seek to rebuild balances after the December attriti n.

The Treasury, as you know, raised $2 billion in cash in an auction of June tax-anticipation bills on the day of the last meeting. Banks, which were enthusiastic bidders at the time, were quite disappointed in the value of the tax-and-loan credit associated with their subscription, as the Treasury cash drain was greater and came sooner than was generally anticipated. Early sales by banks of tax bills helped put pressure on rates during the period. Treasury cash balances at the Reserve Banks should get back in shape in a day or so as tax receipts come in, but there is some risk that direct Treasury borrowing from the System will be required by the middle of next month in the absence of cash borrowing in the market. Although no decisions have been made, a borrowing of $1 to $1-1/2 billion announced before the

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

end of the month is a possibility and would appear desirable from the System's viewpoint in order to avoid the side effects of a low Treasury cash position that has plagued us during the current period.

As far as the outlook for interest rates is concerned, I have little to add to the discussion in the blue book. Certainly, there has been a significant rate adjustment over the past three weeks which may, as is often the case, have gone too far. The market has obviously discounted fully some modest firming of monetary policy, and seasonal factors should favor a stabilization or some edging down in rates. There is a good possibility, should the Committee decide on a firming of money and credit conditions, that the market might view it as beneficial to a more balanced economy in the longer run, and this might tend to limit the strength and duration of any further rise in interest rates. One can never be sure of the market's reaction, however, and it is clear that visible evidence of a slowdown in the rate of economic expansion and of a braking of the inflationary psychology is a prerequisite for more settled market conditions.

I should note that we have added a new firm--Francis I. duPont & Co.--to the list of dealers with whom we do business. DuPont has been conducting operations in Government securities for some time and has been reporting its transactions to the New York Bank for several months. We have carefully reviewed their operations and are convinced that they are capable of making adequate markets in Government securities and will make a useful contribution to the functioning of the market. This brings the list of dealers with whom we do business to 21, of which 13 are nonbank dealers.

In reply to a question by Mr. Mitchell, Mr. Holmes indicated that the dealers had made good progress in reducing their holdings of longer-term U.S. Government securities over the past three weeks. Their current positions in securities due after five years were about $325 million, down from $600 million at the time of the Committee's previous meeting.

Mr. Brimmer asked Mr. Holmes for his judgment of the probable impact on domestic financial markets in the period ahead of various combinations of monetary policy actions, some of which had already been suggested today. The specific combinations he (Mr. Brimmer) had in mind were firming through open market operations together with a discount rate increase (1) of 1/4 point, (2) of 1/2 point, or (3) of 1/4 point, along with some increase in reserve requirements.

Mr. Holmes replied that the market appeared already to have discounted a 1/4 percentage point increase in the discount rate and some concurrent firming through open market operations. If such actions were accompanied by the announcement of a small increase in reserve requirements--designed, say, to absorb about $500 million of reserves effective in mid-January, when a seasonal bulge in reserve availability was projected--the psychological effect of the announcement probably would put some modest upward pressure on interest rates. In his judgment a 1/2 point discount rate increase would have a greater impact on market psychology and interest rates than would the combination of a 1/4 point rise and a small increase in reserve requirements.

In response to a question by Mr. Daane, Mr. Holmes noted that at current levels of Treasury bill rates banks were already under pressure from the Regulation Q ceilings. On a bond-equivalent

basis, the three-month bill was currently yielding around 6-1/8 per cent and the six-month bill around 6-1/4 per cent. At the moment short-term interest rates were under seasonal upward pressures. The duration of those pressures was somewhat uncertain, but on the basis of the normal seasonal pattern one would expect rates to stabilize or perhaps even to decline in January.

Mr. Daane asked whether, if both discount rates and reserve requirements were increased, there would be any technical advantage from the point of view of the Desk in having the two actions announced simultaneously. In particular, would there be any loss in deferring announcement of a reserve requirement increase until early January?

Mr. Holmes replied that he had no particular feeling as to the relative impacts of a combined announcement or two announcements separated by a week or two. In any case, from the technical point of view, the timing of the announcement of a reserve requirement increase was much less important than the effective date of such action. As had been indicated, current projections suggested the desirability of January 16 as the effective date.

In answer to a question by Mr. Maisel, Mr. Holmes indicated that the reserve projections for coming weeks were based on the assumption of a "normal" Treasury balance at the Reserve Banks. He did not know how realistic such an assumption was, particularly

since the level of the Treasury balance would depend importantly on the Treasury's mid-December tax receipts, which were still being estimated.

Mr. Brimmer inquired whether a discount rate increase of only 1/4 point might not be counterproductive, since the market seemed to have fully discounted such an action.

Mr. Holmes replied that he did not think so. Although the market might view a 1/4 point increase as a minimal change, it was likely to be regarded as a signal that further tightening actions by the System were to come.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 26 through December 16, 1968, were approved, ratified, and confirmed.

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

Mr. Partee made the following statement concerning economic developments:

The outpouring of economic good news over recent weeks has been so overwhelming that, for a staff projecting a slowing in expansion, it has seemed almost unbearable. Seldom can I remember a time when the

statistics, including both new numbers and revisions for past months, have shown such dramatic and broadly based strength. New orders, retail sales, employment, and earnings are all up, and the unemployment rate has dropped to the lowest level in many years. The official plant and equipment expenditures survey indicates exceptional strength over the winter quarters, and the business inventory increase in October was far larger than had been expected. To top it off, we will be publishing today a 1 per cent rise in the industrial production index for November along with some further upward revisions for other recent months. Excluding steel, the index since mid-year is now shown to have increased at a 5 per cent annual rate.

Under the circumstances, the staff GNP projection for this quarter has been lifted substantially--again. The current dollar increase, as shown in the green book,[1/] is now estimated at $18 billion, and it is likely to be even higher if inventory accumulation does not slow sharply from the October rate. The GNP gain projected for the first quarter also has been raised significantly, reflecting the further increase in planned plant and equipment expenditures and the effects of higher investment on personal income flows and on consumption. Thus, for the time being at least, much of the slowing in economic expansion that was projected when the surtax was enacted continues to elude us. This is not to say that the tax increase has not had any effect, but rather that its initial impact appears to have been swamped by the unexpected strength in private demands, first in consumption and now in business investment.

The obvious explanation for this strength is that inflationary expectations, in an atmosphere of sharply rising prices and continuing steady increases in production costs, are inducing additional current expenditures in anticipation of future needs. This effect seems strongest with regard to the acquisition of fixed assets, where higher prices are enshrined in the basic cost structure. This would help to explain both the upsurge in plant and equipment, at a time when operating rates are relatively low, and the strength

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

of residential construction in the face of continuing very high financing costs. But the widespread inflationary psychology also may be conditioning business attitudes in favor of somewhat higher levels of inventories than otherwise would be desired, and it could contribute to consumer decisions to satisfy some of their wants now rather than later. Certainly credit demands, on the part of both business and consumers, have been running a good deal stronger than expected.

Anticipatory buying, to the extent that it is taking place, adds a new dimension of instability to the business situation. Additional spending tends to produce its own supporting income, of course, but it seems most unlikely that an expansion based importantly on anticipation of future needs would not sooner or later hit a serious snag. At present, for example, the near-term prospects for both consumption and Government demand would not seem to warrant a major step-up in business inventory investment. Consumer spending, following the mid-summer surge, has advanced in recent months at a more moderate rate, and another upsurge seems a rather remote possibility in view of the increased tax bite in the first half of next year. And Federal purchases of goods and services do appear to be leveling out, in line with budgetary constraints; renewal of a significant uptrend seems neither likely nor possible before well into next year. Real progress towards peace in Vietnam, should it come, would open up a wider variety of options for the new Administration, of course, and could alter substantially both the budgetary and business outlook.

Making no allowance for this last possibility, the staff projection continues to be for a marked slowing in expansion, though from higher levels of resource utilization, through the first half of 1969. Real growth is still expected to slow to 3 per cent or less in the period ahead, and with that slowing should come some--but not much--lessening in demand pressures on the labor force and other markets. The main analytical support for expecting a cooling off is that the Federal budget will be moving strongly into surplus, reflecting both the hold-down on expenditures and a ballooning in tax receipts. In addition, financing capabilities would appear to preclude any significant further rise in residential

construction activity beyond the large increase already reflected in the fourth-quarter estimates.

I still believe that the slower growth model is generally descriptive of the most likely course of developments, but I must admit that the odds favoring a stronger pattern, at least in the short run, have increased considerably in recent weeks. It might well be that business inventory accumulation will continue above expectations for a time and that the plant and equipment survey findings do signal the beginnings of a new investment boom. If so, consumers could be expected to adjust their expenditures to the higher levels of income that would result, and the momentum of this process could continue to carry the economy strongly upward well into the new year. With labor scarcities limiting the nation's effective production potential, the result would likely be a continuation--if not intensification--of current inflationary pressures, carrying with it the potential for a more severe reaction later on.

If the Committee believes that this is too big a risk to take, and I am inclined to think it is, it should act to support recent market developments that serve to increase the cost and limit the availability of credit. But if it does so, the very real risk on the other side should also be taken into account. Aside from possible effects on business psychology, which are difficult to achieve and tricky to interpret, the major impact of increased monetary restraint on spending might not come until next spring and summer, by which time the economy--in line with the standard forecast--could be cooling off for other reasons as well. I will leave it to Mr. Brill to discuss the policy alternatives that seem to afford the greatest chance of steering successfully through this exceedingly difficult time path of events which I fear may lie ahead.

Mr. Brill made the following statement regarding financial developments:

I am indebted to Mr. Partee for resolving the difficult issues of the day, leaving for me the simpler problem of suggesting how monetary policy might extricate

the economy from increasing inflationary pressures. The problem before the Committee today, it seems to me, is not whether to tighten policy, but how and how much to tighten. I say this with full recognition of the lagged effect of policy actions, and in recognition and support of the staff projection of impending moderation in the economy, as the full thrust of fiscal restraint begins to take hold. This must sound like a broken record, I am sure, but I still cling to the faith that economic fundamentals will prevail. As Mr. Partee has indicated, in the near-term outlook the fundamentals are: (a) a fiscal position swinging from large deficit to large surplus; (b) a consumer sector which has had its fling and is now about to be hit by a large increase in required tax payments; and (c) credit market conditions that, if maintained, should sharply limit expansion of housing activity.

Unfortunately, the business community appears oblivious to these fundamentals. In the face of so many factors promising to limit growth in final demands in the months ahead, businesses are adding to inventories at a rapid clip and increasing investment in new plants at a boom rate. It doesn't seem to me likely that the prospects for final demands of consumers and Government are strong enough to validate these business plans; it is more likely that businessmen's inflationary expectations are building in imbalances which will result in a painful correction at some time down the road, and System action is needed now to keep these imbalances from becoming even worse.

If this identification of the critical factor in the present situation is correct, it suggests some criteria for the System in its choice of monetary tools at the moment and for the intensity of their use. The analysis suggests, for example, that the tools employed should have a high degree of visibility to get the message across throughout the business community. If businessmen can be persuaded to believe that our determination to curb inflation is as dogged as in 1966, so much the better. It might prove possible to achieve a modification of business psychology without too strenuous or prolonged a monetary squeeze.

But we dare not count on winning the battle so cheaply. Business loans soared in November--and

continued rapid expansion in inventories would intensify business demands for credit accommodation. The experience of recent episodes of restraint emphasizes that business financing enjoys a preferred status in bank portfolios, and many other categories of would-be borrowers will feel the impact of monetary restraint before business loans are curtailed significantly.

Still, it would be preferable to employ those tools of policy which offer the best odds--even small ones--of mitigating the impact of restraint on nonbank intermediaries and housing, given the present housing shortage, the economic and social costs of perpetuating or deepening the shortage, the somewhat overextended position of mortgage lending institutions, and the imminence of a major interest-crediting period. I do not suggest that housing finance could or should be completely insulated from monetary restraint. But if we have some option, we should be emphasizing the use of tools that might have relatively less impact on the short- and intermediate-term interest rates most competitive with thrift institution inflows, and be less concerned about the impact of additional restraint on long-term rates.

Turning to the issue of the extent of tightening needed, we must recognize that taut conditions already prevail in financial markets, particularly in the market for CD funds, where banks are virtually priced out all along the maturity scale. Banks did anticipate run-offs by aggressive solicitation and pricing of CD's late last month, and thus may be able to cope with substantial run-offs over the balance of December. But CD maturities in January are large, and the pressure of market rates continuing at or above ceilings could bind banks severely and produce strong reactions in the markets in which they make their portfolio adjustments.

Seasonal availability of investment funds in the early weeks of the new year should tend to provide some relief from these pressures, as might renewed availability of Euro-dollar funds after the year-end, and the switching of CD funds into bills would tend to establish an equilibrium ultimately. The balancing process, however, is likely to be painful. In sum, it probably would not require much further tightening in policy to get a sharp reduction in the rate of bank credit growth, although

it will be more difficult to achieve a cutback in credit to business unless loan demands cool off.

Weighing the alternative actions available to the System against the criteria noted above, it seems to me that an increase in the discount rate, reinforced by appropriate open market actions to bring the cost of borrowing to the nonbank public up to higher levels, measures up well on some counts. It is certainly a highly visible act--perhaps too much so for international reasons. But a minor change--such as a 1/4 point increase--might not produce the domestic visibility we seek. Not only has the market already discounted it, but because we took pains in describing the August reduction of a 1/4 point as a technical adjustment, it is likely to prove difficult to persuade the public that rescinding it constitutes a significant increase in the intensity of monetary restraint. If that were the only overt signal of policy action given now, it might become a subject of derision rather than awe.

We can probably achieve more restraint through maintaining market uncertainty, by tightening open market operations and leaving the discount rate at 5-1/4 per cent, than by a mild overt action that has already been overdiscounted. In time, changes in market conditions and in the pace of bank credit expansion--such as those specified in connection with directive alternative B in the blue book[1/]--would convey our message to the financial community.

A one-half point rise in the discount rate would be more impressive, and therefore, according to at least one of the criteria set forth earlier, more appropriate. It might, however, constitute more tightening than

1/ The blue book passages referred to read as follows: "If the Committee decides to seek firmer credit conditions, it might wish to consider a complex including a Federal funds rate around 6-1/8 - 6-1/4 per cent, member bank borrowings in a $550 - $750 million range, and net borrowed reserves of $250 - $550 million. Under such conditions, the 3-month bill rate might move in a 5.75 - 6.10 per cent band . . . . the bank credit proxy is likely to show slower growth. Only a little slowing may become evident in December, with the principal effects likely to be in January and thereafter. Growth in the bank credit proxy could be in a 2 to 5 per cent range, on average, in January, or possibly lower as banks make sales of securities that had been postponed to the new year for tax purposes."

needed--financial over-kill, if I can use a discredited term. It would undoubtedly produce sharp reactions in money and other credit markets, with unnecessarily harsh impact at the maturities most influential on the course of flows to intermediaries. It would aggravate the CD run-off problem, create intense pressure to raise Regulation Q ceilings--a policy action it would be preferable to postpone--and could result in a contraction (not just a slower expansion) in bank credit. There does not seem to be much justification for so abrupt a shift in policy.

There is another combination of policy actions which better satisfies, as I see it, the criteria of visibility, rate structure impact, and intensity of effect. This would be the combination of a small discount rate action--to relieve some of the pressure on the discount window arising when the gap between the discount rate and market rates widens unduly--along with confirmatory open market operations, plus an increase in reserve requirements, announced promptly but with the increase in required reserves not becoming effective until mid-January, after the interest-crediting period at thrift institutions and at a time when reserves have to be absorbed seasonally. By relieving the Desk of the necessity of selling bills to absorb reserves, the package of actions might tend to limit the rise in bill rates, and thereby moderate the impact on institutional flows. Bank adjustments to the higher reserve requirements are more likely to be diffused across the maturity spectrum, and to have a little more effect on long- rather than short-term rates.

To summarize the effects of the alternative actions discussed, and using as a fulcrum the blue book specifications for alternative B--no overt action but tightening through open market operations--I would expect that adding a 1/4 point increase in the discount rate to the package would yield about the same parameters except possibly for a slightly lower bill rate range as market uncertainties are relieved. Adding a reserve requirement increase to the package may result in a shade lower bill rate range, but somewhat more upward pressure on long-term rates, and somewhat lower bank credit expansion in January--say, in the 1 to 4 per cent range compared with the 2 to 5 per cent range under the blue book alternative B. A 1/2 point increase in the discount rate would push all market rates up significantly from present levels, and reduce

> bank credit expansion to a rate hovering around zero. These seem to be the System's options, at least in terms of domestic considerations.

Mr. Hickman asked whether Mr. Brill thought that a 1/4 point increase in the discount rate accompanied by an increase in reserve requirements was likely to push bill rates considerably below current levels and thereby lead to less disintermediation than was projected. He also wondered if it might not be preferable to delay a decision on a reserve requirement increase until there was better evidence of the amount of disintermediation that was likely to occur.

Mr. Brill replied that a 1/4 point rise in the discount rate coupled with an increase in reserve requirements probably would not result in significantly lower bill rates than were projected in conjunction with alternative B in the blue book. With the package of a discount rate action and a reserve requirement action, the three-month bill rate might hold in a 5.80 to 6.10 per cent range in December and decline to a 5.75 to 6.00 per cent range in January. The top of the latter range would thus encompass the currently prevailing rate. With respect to the second question, as Mr. Robertson had noted, under the present lagged reserve accounting procedure an increase in reserve requirements effective in the week beginning January 16 would relate to deposits held in the week beginning January 2. That fact probably limited the

amount of time an announcement of a mid-January reserve requirement increase could be delayed. However, it might be feasible to delay the announcement until a bit after the turn of the year.

Mr. Hayes agreed that such a delay probably would be practicable.

In response to a question, both Mr. Holmes and Mr. Holland indicated that according to their recollection the usual interval in recent years between the announcement and effective dates of changes in reserve requirements had been at least a week.

Mr. Mitchell commented that if the announcement of a 1/4 point increase in the discount rate was expected to have an insufficient impact on market psychology, a simultaneous announcement of an increase in reserve requirements might be desirable. On the other hand, unlike open market operations--which could be flexibly adapted in light of developments--a change in reserve requirements could not be readily reversed.

Mr. Hayes observed that the problem facing the System at the moment was more than usually complex.

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

> When I spoke here ten weeks ago, I urged the Committee to give full consideration to the long-run problems of checking inflation and halting the

deterioration of our international trading position. That would still be my counsel today--again with emphasis on the long-run nature of these problems.

In the past three months the main components of the U.S. balance of payments--with one important exception--have not changed greatly so far as we know. I will mention just two of the principal items. First, the merchandise trade surplus in the two months September and October still averaged an annual rate of under $1 billion. Second, foreign net purchases of U.S. corporate stocks apparently leveled off in the second and third quarters at an annual rate of nearly $2 billion.

Over all, by watching the weekly and monthly data on official reserve transactions and on changes in U.S. liabilities to foreign banks and branches, we can estimate the net position on current account, Government economic aid, and all private capital movements other than the inflow of liquid funds through commercial banks abroad. With rough adjustment for seasonality, the only good months this year were June and July. For the third quarter as a whole, including July, the deficit measured in this way was at an annual rate approaching $2 billion. In the four months August through November it was apparently running at an annual rate of about $4 billion--perhaps a little less than that in late summer, but apparently somewhat more in October-November.

The one large recent change relates to means of financing the adverse balance of which I have been speaking. This change is the cessation of large net inflows of funds to U.S. banks through their branches abroad since the middle of September. In the previous 12 months there had been a net inflow of about $3-1/2 billion. If this inflow through commercial banks abroad is now drying up and if the underlying payments position is not improving significantly, we must not be surprised to see large additions to the net claims of foreign monetary authorities on the United States. This in fact was occurring in October and November.

No one can say when the next international exchange market crisis will hit someone, or hit us. Talk of a mark revaluation coming soon after the September 1969 German elections, if not before, is

not likely to have been quenched by Germany's recent actions. Next March the French people and their government will be making crucial decisions about money wages and inflation.

The United States should be raising defenses against a coming crisis. One way--essential in the long run--is to slow our inflation and thereby improve the current account of our external transactions. It is hard to see other immediate possibilities. Intensification of capital controls or further enlargement of swap lines in advance of clear need would be of doubtful value, I think. Some equilibrating changes in currency parities may be required eventually. At the moment, however, an overt effort by the United States Government to hasten such changes would, as I see it, only tend to accelerate the thing we have to fear, and need to guard against: namely, gradual weakening of foreign habits of holding dollars. In any case, changes in parities will not remove the necessity of restraining U.S. inflation.

The principal contribution that monetary policy can make to the defense of our external financial position is through stability of the price level. Some academic writing about "the policy mix" seems to assume that monetary policy affects the balance of payments primarily through interest rates and their effects on capital movements. This seems to me a mistaken emphasis. No doubt monetary policy aimed at slowing inflation will bring higher interest rates--at least so long as expectations of inflation are as widespread as they now are. But it is the slowing of inflation that is most needed for dealing with the balance of payments problem, not higher interest rates *per se*.

Let me spell out what I mean. First, large inflows of short-term capital, such as we were getting through the Euro-dollar market until September, do not make a lasting contribution to equilibration of payments, and therefore are far less to be desired than is an enduring improvement of our competitive position. Second, flows of capital are by no means determined solely by interest rates. As you know, the big inward movements of long-term capital in the past year have been to buy equities, not U.S. Government bonds--and not U.S. corporate bonds except those which U.S. companies were selling on relatively unfavorable terms to comply with the direct investment

controls. In the case of short-term funds, the past year has amply demonstrated the importance of confidence or lack of confidence in currency parities as a factor influencing availability of funds in the Euro-dollar market. In the real world we have very little power to fine-tune the flows of capital to and from the United States through interest rate policy.

To sum up, so long as expectations of depreciation of the domestic value of the dollar persist and fears of external depreciation lie below the surface, high interest rates in the United States are a necessity rather than a virtue. The test of an effective monetary policy, for the balance of payments as well as domestically, is not what it does to interest rates but whether it helps in the long slow process of halting the inflation of prices.

May I now add a few words on the question of whether, or to what extent, action by the Federal Reserve at the present juncture should be inhibited by fears of repercussions on the position of sterling and--through sterling, at one remove--on the dollar itself. I would like to say two things. First, irrational speculative reactions are very difficult to analyze and predict. From the point of view of U.S. balance of payments policy, there may be a choice between taking measures desirable for checking U.S. inflation, on the one hand, and on the other, not taking those measures because they might indirectly react adversely on the dollar through speculative capital flows. As Mr. Solomon has already suggested, the difficulty of choosing between such alternatives may be narrowed if the first alternative is limited to taking whatever anti-inflationary actions appear absolutely essential, not merely desirable. As I see it, this does argue against dramatic announcement effects.

Secondly, under present circumstances there is little reason to fear that moderate changes in U.S. money market rates would generate interest-sensitive flows of funds out of sterling, or inhibit inward movements. At present, sterling interest rates in the open part of the London money market are typified by the 7-1/2 per cent rate on three-month lending to local authorities. Three-month Euro-dollar money has been around 7 per cent for several weeks--which compares with 6 per cent at the end of September. Inflows to sterling

are not occurring, because no one wants to move in that direction uncovered and the cost of forward cover is prohibitive. The 3-month forward discount on sterling went to 7 per cent per annum last Wednesday, and was still above 4 per cent yesterday.

It should also be noted that U.S. banks' Euro-dollar borrowings have been fluctuating widely since September, with no clear trend. Apparently the banks have been willing to pay rising rates to hold on to funds, but have not found much availability of new Euro-dollar money. The flight from the franc went mainly into German marks, and there was probably some movement into marks from dollars too. After the crisis the Euro-dollar market remained fairly tight. In the week from December 4 to the 11th, however, U.S. banks were able to increase their borrowings considerably. Speculative movements out of sterling may have helped them, and probably also the ebbing of mark speculation and the German Federal Bank's market swap operations.

Under all these circumstances, a moderate tightening of U.S. monetary conditions might well lead to a further rise in Euro-dollar rates. This might be followed by a similar rise in London rates for local authorities. If not, and if the interest rate incentive for moving, uncovered, out of sterling into dollars were to be increased a little, it is hard to imagine who would respond to this additional incentive. The treasurers of international companies, who make it their business to avoid currency depreciation losses even at a sacrifice of interest income, have no doubt already moved all they can. Sterling area central banks still thinking of making a change in long-standing habits of where to hold their reserves, are not going to be motivated to act by small changes in rate relationships. Finally, the group that might conceivably move on a covered basis--covered, that is, back into sterling--is limited mainly to financial institutions in Britain. For these investors, the large discounts on forward sterling have already created large covered interest incentives to move into dollars. For them, the British exchange controls are an effective deterrent, and a slight change in interest differentials would mean nothing.

In brief, speculative attitudes and the forward discounts on sterling reflecting these attitudes will

be far more important determinants of flows out of or into sterling in coming weeks than interest rate relationships will be.

Mr. Hayes then began the go-around of comments and views on economic conditions and monetary policy with the following statement:

The business outlook remains very strong, with no real evidence yet of a slowdown. Indeed, nearly all the data becoming available since the last meeting have contributed to a picture of greater-than-expected expansion. Not only is the fourth-quarter GNP gain likely to be almost as large as that for the third quarter, but more doubt has now been cast on the validity of projections showing a much more moderate growth rate in the first half of 1969. Commerce-SEC data on future capital spending and the 3.3 per cent unemployment figure were the most dramatic of the new statistics. Along with the disturbingly high recent increases in major price indices, they underlined the fact that an inflationary spiral, abetted by a very tight labor market, continues to be our most challenging problem.

Current and prospective balance of payments trends continue to give cause for great concern, even though the recorded liquidity deficit for 1968 promises to be relatively small. As for 1969, we are almost sure to see some considerable deterioration on capital account since capital inflows have been so large this year. Unless we can achieve a major improvement in the trade balance--which does not at the moment look terribly hopeful--the underlying liquidity deficit next year may be of the same order of magnitude as the estimated $3.5 billion for 1968. And unfortunately the recorded liquidity balance in 1969 will undoubtedly be much closer to the underlying balance than in 1968 because the outlook is poor for further large increases in nonliquid dollar holdings of monetary authorities. Also, since there seems to be little likelihood of additional inflows of private foreign funds via the overseas branches of U.S. banks on anything like the magnitude of the current year, 1969 may also bring an official settlements deficit in the $2-1/2 to $4 billion range in contrast with this year's expected surplus. All of this, of course, points up the vital need to improve the trade surplus.

As I have said at several recent meetings, I am disturbed by the persistent tendency of credit proxy growth rates to exceed preliminary projections by wide margins. There is little doubt in my mind that the growth of bank credit and the various monetary variables remains excessive in view of the inflationary pressures in the economy. If the current December projection for the bank credit proxy is realized, it would mean a fourth-quarter gain in bank credit of 11-1/2 to 12 per cent following a 13 per cent rise in the third quarter. While the recent strong rise in bank credit in part reflects reintermediation through large CD's, this is not reassuring in light of the fact that total credit flows also appear to be rising rapidly. The member banks in our District expect business loan demand to remain strong during the early part of 1969. It is interesting to note that so far deposit inflows to the thrift institutions--as well as the growth of mortgage holdings--have held up well despite the pronounced firming of market interest rates, no doubt in part because there is less "hot money" in the thrift institutions now than in 1966. However, the year-end interest crediting period could uncover weakness here that is not yet apparent in the statistics.

There is no doubt in my mind that the major objective of monetary policy under these circumstances should be to seek an appreciably slower rate of bank credit expansion as a contribution to the long-sought slowing of the economy. However, I would advocate gradual and persistent pressure in preference to any massive moves, but any action or combination of actions must be significant enough to have some effect on inflationary psychology. I would tend to rely mainly on open market operations, together with supporting discount rate action.

A good case can also be made for a change in the near future in reserve requirements. A modest increase could play a useful role in bringing home a tighter policy to all banks and, if timed to occur in mid-January, could obviate the need for sizable open market operations to absorb reserves. However, I have some feeling of reluctance to announce a reserve requirement change at this moment, when sterling is in such a delicate state. While the situation may turn out to be no less touchy a couple of weeks from now, I nevertheless have some preference for seeing this decision deferred for a week or two in

the hope that it may then be possible to assess a little more accurately the degree of vulnerability of the international situation.

It seems to me that the Committee should instruct the Manager to seek somewhat firmer money market conditions. In any case, regardless of any prospective discount rate action, we might have in mind a Federal funds rate in the range of 6 to 6-1/2 per cent, with emphasis on the upper part of this range if the discount rate is raised. Member bank borrowings might be from around $600 to $800 million, which might imply net borrowed reserves of $300 to $600 million. I would be inclined to accept whatever range of bill rate levels the market might itself establish, within reason of course. As a matter of fact, it is not at all unlikely that short-term market interest rates have largely anticipated a firming of monetary policy including a 1/4 point rise in the discount rate.

As for the directive, I like alternative C as proposed by Mr. Robertson. It seems to me that we might do without the proviso for the next four weeks if explicit firming action is taken at this time, but I do not feel too strongly on this score. In any event I would not be disturbed if the rate of credit growth were to drop close to zero for a month or so.

At a special meeting of our directors last Friday they voted to increase the discount rate by 1/4 percentage point. It is my understanding that the boards of a number of other Reserve Banks have taken similar action, and it would be my hope that the Board of Governors will approve these actions promptly. While I had earlier felt that any discount rate action by the Reserve Banks might better be deferred until after our discussion today, I realize that the happenstance of the meeting dates for many of the Banks' boards of directors was a valid reason for advancing this timetable. Another reason why I had favored some delay on the discount rate was the very delicate situation with respect to sterling which manifested itself in the early part of last week. Since then we have had favorable British trade and balance of payments news; and while the market effect of this news has been a good deal less than might have been hoped, nevertheless I would think that the British position will not be appreciably harmed by a 1/4 point increase, much of which certainly has been discounted already by market rates.

After all, it is market rates which are of the greatest significance with respect to short-term capital flows into and out of the United Kingdom.

Our directors considered the alternative possibility of a 1/2 point increase. However, I recommended a 1/4 point increase both because of the delicate position of sterling and of the exchange markets in general and because of the disturbed and pessimistic state of mind in our own bond and money markets. It seemed to me unwise for the System to make such a sharp move as to put severe pressure on the bill market and other markets at a time when seasonal pressures are especially high in any case and when an artificial pattern of open market operations has been forced by an exceptionally low Treasury balance and a complex series of foreign funds flows.

I am quite aware that we may have to make an additional discount rate move before many weeks or months have passed, either to provide a stronger psychological signal or to support the firmer open market policy which I am now advocating. I believe it would be clearly preferable to consider this possibility as a separate step following a full review of conditions, including the tender international situation, after the turn of the year. In brief, it seems to me that what is needed in the way of monetary policy now is a gradual but steady increase of pressure on the banks' reserve positions, through a judicious combination of policy actions, until such time as we see progress in our anti-inflationary efforts.

Since our chief immediate objective is to slow the expansion of bank credit, and since Regulation Q has barely begun to bite, I would defer consideration of any change of the ceilings at least for several weeks until we can review the whole situation in the new year. If in the meantime the existing ceilings tend to put the banks under some increased pressure, so much the better from a domestic point of view.

Mr. Francis commented that inflation was continuing at a 4 per cent annual rate, and expectations of future inflation appeared to be heightening. The fiscal stance of the Government was changed about five months ago, but thus far economic excesses

had not been reduced. There seemed little question that a restrictive monetary policy had to be pursued in order to provide the necessary total restraint to end the inflation. But an apparent conflict arose between the desirability of taking effective action against inflation and the desirability of preventing a further rise in interest rates. Under such conditions in the past, attempts had been made to use devices other than simply restricting bank reserves, but with very little over-all success in slowing inflation.

It should be pointed out, Mr. Francis continued, that raising reserve requirements--as opposed to selling securities--in the hope of providing monetary restraint while minimizing upward pressure on interest rates had not generally been able to accomplish the desired objective. For example, in January 1968 the System had raised reserve requirements, absorbing $550 million of reserves, to obtain some monetary restraint without placing direct upward pressure on interest rates. But the effect of that action had immediately been more than offset by greater open market purchases, and total Federal Reserve credit, even adjusted for the change in reserve requirements, continued to go up at an excessive 15 per cent annual rate in the first quarter of 1968.

Mr. Francis recalled that indirect attempts at credit restraint had had a similar ineffective result. The System had

imposed regulation on banks' ability to attract time deposits; it had increased and broadened margin requirements on stocks; it had used moral suasion with bankers; and it had changed discount rates. Yet, month after month, the total effect of the System's actions had remained expansionary; Federal Reserve credit had continued to expand rapidly.

Since neither fiscal actions nor selective monetary controls had produced desired results, Mr. Francis suggested that now was the time to return to a proven course of action. Control of monetary aggregates, when used, had been effective in slowing spending, both in this country and others. In the past four years, those monetary aggregates had usually been rising at record rates, and spending had been rising excessively. In one period, 1966, the aggregates had been slowed, and after a brief lag total spending had slowed and interest rates had fallen.

It seemed to him, Mr. Francis said, that the System should now avoid contriving special devices in a vain hope that inflation could thereby be curbed while temporarily higher interest rates were avoided; instead, the System should begin to use its traditional tool of over-all money and credit limitation. In view of the serious inflationary situation, he recommended that steps be taken immediately to slow the rates of increase of Federal Reserve credit, the monetary base, and the money supply. The current high interest rates were, in great part, a reflection of strong inflationary expectations. The adverse effects of any resulting temporary rise in interest

rates from a slowing in the growth of monetary aggregates were likely to be more than offset by the benefits of a more balanced economic expansion. Lower interest rates were likely next summer only if the rate of monetary growth was now slowed, reducing inflation and inflationary expectations.

Mr. Francis said that a recent study done at the St. Louis Reserve Bank indicated that with the existing stance of fiscal policy, if money continued to grow at a 6 per cent annual rate throughout the coming year, gross national product would rise at an excessive 8 per cent annual rate. Under those conditions real output might rise about 4 per cent and prices would probably continue to go up at a 4 per cent rate.

If money was slowed to a 4 per cent annual rate of growth, Mr. Francis continued, the Bank's research indicated that GNP would rise at a 7 per cent rate in the first half of next year and at a 6 per cent rate in the second half. Some of the slowing might initially be in real product, as inflationary forces take time to extinguish, but the estimate was that such a course in spending would be consistent with a 3.5 per cent rise in real output and a gradual decline in the rate of inflation from the current 4 per cent rate to a 2.5 per cent rate in the last half of next year.

Of course, Mr. Francis added, if monetary policy became more restrictive, inflation could be eliminated more quickly, but

economic activity could become unduly restrained. For example, the study indicated that if money were held unchanged over the next four quarters, growth in total spending would slow sharply from the recent 9 per cent rate to a 1 or 2 per cent rate by the second half of next year, with real product declining. He would place in the record a table of the Bank's projections of GNP growth next year under various money growth assumptions.[1/]

Mr. Francis said he realized the results of the recent research might be challenged, but until they were refuted by empirical evidence he felt they were the best guide to monetary actions. Hence, he urged that the Committee direct the Manager to increase Federal Reserve credit and the monetary base at rates which would foster a 4 per cent rate of growth in money. If money growth varied from that 4 per cent trend in one period, attempts should be made in immediately succeeding periods to return to the directed course. Later, as inflationary pressures gradually receded, the target rate of money growth might be reduced to 3-1/2 or 3 per cent.

It was the view of the board of directors of the St. Louis Bank that the discount rate should be raised by at least 1/2 of a percentage point, Mr. Francis reported. Market rates had increased that much or more since late last summer. With appropriate open

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1/ Appended to this memorandum as Attachment B.

market policy he saw no need for an increase in reserve requirements. However, if the decision were to combine an increase in the discount rate with an increase in required reserves, he would favor a simultaneous announcement of the two actions.

Mr. Kimbrel remarked that for some time he had believed the rate of credit expansion to be too great for the continuing health of the economy. At the same time, he had recognized the many constraints involved in adopting and executing a firmer policy and the risks inherent in adopting the more restrictive policy. He had left the last meeting wondering if the Committee really had not gotten enough new evidence to justify a more restrictive policy, as had been implied by some persons in the discussion. What was especially disturbing at the moment was the development of inflationary expectations.

Therefore, Mr. Kimbrel said, since the last meeting of the Committee he had been making a sort of informal poll of the state of inflationary expectations held by Sixth District directors--both at the home office and at the four branches--and by businessmen and bankers. He had made no formal tabulation, but the consensus seemed to be practically unanimous that further inflationary developments were anticipated and that it was a wise man who made his decisions to spend and invest in accordance with that certainty of further inflation.

Mr. Kimbrel observed that in the Sixth District the signs of a slower growth noted earlier had apparently given way to a faster tempo. Nonfarm employment, following two months of no change, probably rose in November. Despite only a small gain in new instalment loan extensions at banks in October, the outstanding volume rose sharply and in November business and consumer lending at large District banks was stronger. Construction activity had exceeded by a substantial margin the strong national performance during 1968.

Thus, Mr. Kimbrel continued, he had been sympathetic with his directors late last week when they concluded that an increase in the discount rate would be an appropriate action as a step toward dampening the state of inflationary expectations. They debated for some time the appropriate size of the increase. They recognized that some of the pressures pushing up the rates might be temporary. They considered the possible disintermediation effects of too large an increase and the possibility that an increase of as much as 1/2 percentage point might strengthen inflationary expectations rather than dampen them. They also doubted that this was an appropriate time, during a change of Administrations, to take the more dramatic move toward raising the rate by 1/2 rather than 1/4 percentage point. They also had debated the interpretations that could be assigned to the change by foreign sources. It would be preferable, they believed, to raise the rate by the lower figure, since that could be justified on technical grounds.

As for the directive, Mr. Kimbrel said he favored alternative C proposed by Mr. Robertson. The market conditions set out in the blue book in conjunction with the firming alternative would seem appropriate with an increase of 1/4 point in the discount rate accompanied by an early announcement of upward adjustment of reserve requirements. He would prefer to see any rise in Regulation Q ceilings postponed for the time being.

Mr. Bopp remarked that the green book and the reports by the staff gave ample evidence of the developing economic strength and the consequent need for more restraint. He would add only that the staff at the Philadelphia Bank projected even greater strength in the second quarter of 1969 than suggested by the green book estimates.

Mr. Bopp said that after learning of the discount rate action of other Reserve Banks on last Thursday evening (December 12), he felt that this was an opportunity to test the Philadelphia Bank's ability to respond promptly in considering a rate change, as was envisioned in the report on the discount mechanism. The occasion was felt to be appropriate because the directors had been disposed to move a week earlier and had refrained primarily because of the absence of the Chairman and Deputy Chairman, who were here in Washington. The decision to call a special telephone meeting was made Friday morning. The meeting was held at 10:30 with seven

directors available. He recommended an increase of 1/2 percentage point to give clear notice to the market of the Federal Reserve's intention to restrain the growth of money and credit. The directors voted for the 1/2 point increase; but they would accept a 1/4 point increase if that was the maximum that the Board of Governors was prepared to approve.

Mr. Bopp added that if the discount rate were raised, it would be important to follow up with a more restrictive open market policy. He would prefer to see a smaller increase in bank credit than the Board's staff projected on the basis of existing money market conditions. Inasmuch as the market probably had not fully discounted an increase in the discount rate of 1/2 point, and inasmuch as some seasonal factors would be providing pressure, the Desk might be able to let the market do some of the tightening on its own. In any case, the correct course, as he saw it, was to move gradually toward more restraint and not attempt to make up for past increases in money and credit.

Mr. Bopp said he would favor adoption of alternative C of the draft directives. However, he was not at all certain that the money market conditions associated with the firming alternative in the blue book would accomplish the necessary reduction of growth in the money and credit aggregates. The Desk should give priority to slowing down growth in bank credit even if that required tighter conditions in the money market than those described in the blue book.

Mr. Hickman commented that a pervasive and persistent inflationary psychology was preventing the economy from achieving a balanced and sustainable rate of growth. Unexpected strength in consumer outlays and capital spending indicated that the GNP gain this quarter would be considerably above recent expectations. Consumers were offsetting smaller gains in income by reducing personal savings and by taking on personal indebtedness at a record rate. The November rebound in retail sales coupled with the sharp upgrading of capital spending plans over the near term suggested stockpiling on the part of consumers and businessmen as a hedge against further price inflation.

Mr. Hickman said he agreed with the Board's staff that economic activity should moderate somewhat during the next six months, assuming of course that consumers responded as predicted to smaller increases in disposable income. Nevertheless, expected gains in GNP were still too high to permit any measurable easing of price pressures or significant improvement in the nation's balance of trade. In short, despite relatively low plant utilization rates in manufacturing in general, the economy had over-full employment and price inflation. He added that the situation had not been essentially different in its broad outlines last summer, when the Committee also had been faced with an economy operating at forced draft with price inflation.

In that environment, Mr. Hickman saw no justification for continuing the expansionary monetary policy that in practice had been in effect since the fiscal package of last summer. The appropriate policy was to put the commercial banks under moderate pressure, so as to keep them on the razor's edge of disintermediation. In his opinion, the 91-day bill rate should be kept in the 5.75 to 6.00 per cent range, which would discourage further intermediation and make it difficult for banks to recapture all the CD's that they might have lost at mid-month. He would not favor any further increase in Regulation Q ceilings at this time, and he would not favor any other immediate dramatic action on the part of the Board of Governors that might have the effect of shaking confidence in weak currencies without slowing the growth of bank credit. Since he felt that growth in the bank credit proxy should not exceed 6 per cent, as a maximum, he was obviously not pleased with the 9 per cent growth rate (including Euro-dollars) projected by the staff for December. Accordingly, he would vote for alternative C of the draft directives. On the other hand, he would emphasize that he wanted credit restraint, not a crunch. Thus, he would be disturbed if the rate of bank credit expansion fell much below 4 per cent and would therefore prefer a two-way proviso. The board of directors of the Cleveland Reserve Bank had acted last Friday to increase the discount rate by 1/4 percentage point, and he favored early approval of that action by the Board of Governors.

Mr. Sherrill remarked that the information that had become available since the previous meeting clearly indicated the need for firming through open market operations and possibly also through other instruments of monetary policy. He believed the firming actions taken should be visible. However, because he also thought they should be carefully controlled, he would rely heavily on open market operations. He favored alternative C of the draft directives.

In addition, Mr. Sherrill said, he was inclined toward an increase in the discount rate of 1/4 percentage point. He would not advocate any other action at present because he thought the System had a more powerful means at hand for achieving the needed effect on expectations. Given continuation of the current Regulation Q ceilings, firming actions of the type he favored probably would trigger a sizable amount of disintermediation--if not during the rest of December then in January when banks were faced with large CD maturities. As pressures increased, bankers undoubtedly would begin to probe to discover the Board's attitude concerning the Q ceilings; and if it became clear that the Board was not disposed to raise the ceilings, their expectations would change rapidly. Bankers would in turn communicate their views to businessmen. That indirect approach seemed to him to offer a better hope of changing businessmen's expectations than would the announcement effects of particular policy actions.

Mr. Brimmer recalled that at the previous meeting of the Committee he had indicated that information concerning the 1969 balance of payments program probably would be available to Committee members by the time of today's meeting. As of the moment, however, the Administration still was not in a position to make an announcement, although it was hoped that the program could be made public within a few days. Because of the conflicting proposals for a foreign credit restraint program for banks in 1969, there had been agreement within the Government, including the Federal Reserve, that for the present the 1968 program should be continued essentially unchanged, with only a few minor technical modifications. The program would be reviewed in early 1969 and he would report to the Committee at that time.

With respect to monetary policy, Mr. Brimmer thought that determined, but not drastic, firming action was desirable. He believed the System could best serve its over-all objectives at this time by making use of a combination of policy instruments. In that connection, he had been impressed by the assessments given this morning by Messrs. Holmes and Brill of the possible market impact of various combinations of policy actions. He was presently inclined to favor a 1/4 percentage point increase in the discount rate, but he wanted to hear the views of all the Committee members before reaching a final position with respect to both the discount rate and possible reserve requirement action.

Mr. Brimmer indicated that he favored alternative C of the draft directives. Since open market operations would have to be modified to accommodate whatever additional policy actions the Board might take, he would not attempt to specify any particular configuration of target conditions in the money and short-term credit markets.

Mr. Maisel remarked that the System seemed to be faced with two main alternatives for policy at present. One was to attempt to curtail expansion in the monetary aggregates by tightening through open market operations and making a technical 1/4 point increase in the discount rate. The second was to seek a significant effect on expectations by taking additional or stronger actions, perhaps including a 1/2 point rise in the discount rate, an increase in reserve requirements, or use of moral suasion.

In his judgment, Mr. Maisel said, the System's record in estimating the psychological effects of its policy moves was not outstanding. For example, it had been surprised by the effects on expectations of its actions in 1966 and again this summer. When faced with a situation in which the range of possible outcomes was wide, one could act either as a gambler or a risk averter. Personally, he thought it would be better in the present situation for the System to act as a risk averter, and not gamble on achieving some particular impact on expectations.

Mr. Maisel said he would favor alternative C for the directive, in the expectation that under such a directive the Desk would steadily exert pressure on the market. The proviso clause was of particular importance now in view of the existing uncertainties and especially in light of the fact that the System would be supplying a very large volume of reserves in the next five weeks to offset the effects of technical factors. If reserve demands should rise sharply he would hope that the Desk would not fully satisfy them. Rather, it should employ a graduated response under the proviso clause, letting the market tighten itself rapidly as reserve demands increased.

Mr. Daane said that the proper course of action for the System seemed clear; the only questions concerned the pace at which the System was to move and the particular forms of its actions. Without prejudicing the positions he might take in the Board's deliberations later today, he would note that he agreed with those who favored persistent firming rather than dramatic or abrupt action. In his judgment the System had overreacted in easing during the summer, and he hoped it would not overreact in firming now. That view had been reinforced by Mr. MacLaury's comments on the precariousness of the British situation, and by the observations of Messrs. Solomon and Hersey.

In brief, Mr. Daane remarked, he favored a step-by-step approach, beginning with a 1/4 point increase in the discount

rate and firming through open market operations. Later, if circumstances warranted, further actions could be taken--perhaps an increase in reserve requirements effective in January, another increase in the discount rate, or both. It was his personal judgment that by taking a dramatic combination of actions now the System would risk much on the international side. At the same time, it would not gain appreciably in terms of its domestic objectives; the latter would be better served by an orderly sequence of actions over a period of time. He favored alternative C for the directive.

Mr. Mitchell commented that there seemed to be agreement today on the need for tightening but a good deal of disagreement on the appropriate means. Personally, he thought the System's actions should be definite and definitive; he was inclined toward a 1/4 point rise in the discount rate, a small increase in reserve requirements, and firming through open market operations. In his judgment such a combination of actions would not be "dramatic," but it would be noticeable.

Certainly, Mr. Mitchell continued, it would be desirable to offset the easing of short-term interest rates which the blue book said might develop in coming weeks in the absence of policy action. He inferred from Mr. Brill's remarks today that the

combination of policy actions which he (Mr. Mitchell) favored would not produce an unduly large amount of disintermediation at banks. In any case, the System had tools--open market operations and Regulation Q ceilings--that could be brought to bear if necessary for keeping the amount of disintermediation within appropriate limits.

Mr. Mitchell remarked that Mr. Francis' objective of slowing expansion of the money supply evidently was about to be achieved; the staff projected money supply growth at an annual rate in the range of 3 to 6 per cent in December and at a lower rate in January even if policy remained unchanged. He (Mr. Mitchell) agreed that it was important to slow the growth in the monetary aggregates, including bank credit, and he thought that result would be assured by firming actions of the type he had suggested. There remained the question of whether the pattern of interest rates that emerged would be appropriate to the current situation, including that in the foreign exchange markets. None of those who had spoken about the latter problem today had described the mechanism by which System policy actions might produce a crisis for sterling, but it seemed to be agreed that somewhat higher U.S. interest rates in themselves would not endanger sterling.

Mr. Mitchell said he was inclined to agree that the domestic economic expansion would slow as a result of fiscal restraint--if not in the first quarter, then in the second. Moreover, the incoming Administration probably would be inclined in the direction of economic restraint. If the System was to take action to deal with the existing inflationary psychology, the present moment might offer almost the last chance. In his judgment that argued for a combination of definitive actions now, rather than a series of measures spread out over time.

Mr. Mitchell indicated that he was prepared to vote for alternative C for the directive. However, he would prefer to abbreviate the statement of the Committee's general policy stance at the end of the first paragraph to emphasize the primary objective of reducing inflationary pressures. Specifically, he suggested a statement to the effect that it was the Committee's policy "to foster financial conditions conducive to the reduction of inflationary pressures." In the second paragraph he would omit the word "somewhat" from the phrase "with a view to attaining somewhat firmer conditions in money and short-term credit markets."

Mr. Heflin reported that Fifth District business exhibited the same general trends and characteristics reflected in the latest data on the national economy. Recent information for the District reflected a rather general exuberance, with only some sectors of

the textile industry reporting any slackening of activity. He continued to hear an increasing number of expressions of concern over the persistence of inflationary pressures.

Mr. Heflin commented that the latest data on the national economy were disturbing and pointed up what now appeared to be a persistent tendency on the Committee's part to overestimate the moderating effects of the surtax. As he interpreted the recent figures, the economy might well be experiencing a speedup rather than a moderation. He remained convinced that the fundamental problem was the strong inflationary psychology that now seemed to have permeated all business, consumer, and financial decisions. The unexpectedly large increases in inventories suggested that much of the current increase in expenditures was of an anticipatory nature, and that seemed to be the case with consumers as well as businesses. Similarly, inflationary expectations appeared to have taken much of the sting out of any restraining effects that high and rising interest rates might be expected to exert. Businessmen could be counted on to recognize indebtedness as an excellent hedge against inflation and he believed that that was a major factor in the continuing large volume of credit demands.

Over the past several meetings, Mr. Heflin said, he had been reluctant to support any overt tightening move largely out of a concern over unsettled conditions in domestic and international markets. Moreover, he kept hoping that the expected deceleration

in the business advance would materialize and allow the System to avoid actions that risked serious disruption of credit markets. The latest business statistics had dissipated those hopes and, while he recognized that the tax burden would increase in the first quarter, he was convinced that that would not be a sufficient offset to the strong inflationary psychology the System was confronted with. He thought that additional measures were necessary and that the problem had assumed a degree of urgency that required those measures to be taken sooner rather than later.

From the standpoint of the System's contribution to a solution of that problem, Mr. Heflin thought the best thing that could be done today was to put the business and financial community on notice, as unequivocally as possible, that the System was determined to slow down the recent excessive money and credit growth. He believed that the best way to do that was through a 1/4 percentage point discount rate increase coupled with an increase in reserve requirements, and he favored immediate announcement of both moves.

As for open market policy, it seemed to Mr. Heflin of prime importance to shape operations with a view to slowing the rate of bank credit and money growth. He believed that to be the case regardless of what the System elected to do with the discount rate. Many sophisticated observers had come to regard credit and

money growth as the principal indicators of the System's policy posture and they probably would watch those indicators as a test of the System's determination. In the current situation, he thought it was important that bank credit not be allowed to grow any faster than 6 to 8 per cent per year. A somewhat slower rate might be desirable, although he would not want to see any absolute decline--especially one associated with large-scale disintermediation and demoralized markets. He would favor a directive instructing the Desk to seek somewhat firmer conditions than had prevailed last week, with Federal funds trading at 6 per cent or above and member bank borrowings moderately higher than in recent weeks. He favored alternative C of the draft directives.

Mr. Clay commented that accumulating evidence underscored the inappropriateness of monetary policy in recent months. It had been geared to a pattern of economic activity that had not materialized. On the contrary, it had resulted in excessive growth of bank credit, which had increased the demands upon resources and intensified price inflationary pressures. Moreover, the course of those developments, including the persistent upward movement of costs and prices, had heightened the prevailing inflationary expectations among both businessmen and consumers.

That pattern of developments, Mr. Clay felt, had to be modified so as to reduce the demands upon the economy and to

alleviate the excessive pressures upon resources and prices. As a part of that program, the strong inflationary expectations had to be dispelled. That could not be accomplished without slowing down the rate of economic expansion. Every reasonable effort needed to be made to avoid a downturn in economic activity, but it had to be admitted that such a risk existed. In the effort to avoid such a development over recent months, the policy pursued had compounded the problem and increased the very risk that it sought to avoid. Continued failure to move policy to a restrictive posture would involve an alternative risk of accelerating the cost-price inflation.

Mr. Clay said that omission of an action to increase the discount rate by the Kansas City Reserve Bank last week was based upon a view that the initial restrictive action should be taken by open market operations. An increase in the discount rate could be justified in terms of interest rate alignment. A change in the discount rate also could be used to give a signal to the market. The main need, however, was a shift to a slower rate of expansion in member bank reserves and bank credit, and that could be better accomplished by a change in open market operations. Presumably, that change also would affect interest rates. It seemed a better choice, however, than to begin with the interest rate repercussions of a discount rate adjustment before a change in open market operations was instituted. Then the discount rate change could follow

as a routine action. As of now, that view seemed to be more related to a discount rate increase of 1/2 than 1/4 of a percentage point. If the discount rate action did come at the outset rather than later as suggested here, the Kansas City Bank could be expected to fall in line at the next regular establishment of its discount rate.

Mr. Clay noted that an increase in member bank reserve requirements was another means by which reserve availability and bank credit growth could be restrained. If such action was taken, the proposed open market operations change would need to be modified accordingly. There was room for concern about a delay of implementation of reduced reserve availability until mid-January, however, despite seasonal forces.

Mr. Clay said that alternative C was his choice for the directive.

Mr. Scanlon said he would summarize the remarks he had prepared on District economic conditions and national financial developments, and submit the full text for the record. He then summarized the following statement:

> The evidence of recent weeks strongly supports the view that private spending has not been dampened and, indeed, may be accelerating. In the Seventh District we find an increasing acceptance of the prospect of very large wage increases and further price increases. Consumer buying, construction, and business investments in inventories and plant and equipment are all vigorous.

There is a strong presumption that the additional momentum generated by the private economy in the second half of 1968 is related to the highly expansionary monetary policy as measured by growth in any of the aggregates of liquid assets or credit. Inflationary forces took time to reach their current strength, and it would be difficult and undesirable--perhaps impossible--to deflate plans and expectations quickly. But a start should be made.

Christmas sales of both hard and soft goods are reported to be excellent, with many customers "trading up" (buying more expensive merchandise). Sales of new and used autos in recent weeks have been sufficiently strong to cause manufacturers to project 1969 sales almost as high as in 1968. Truck sales are expected to at least equal 1968.

Some business firms report the supply of available workers to be the poorest since World War II. They refer not only to skilled workers, but to persons with sufficient aptitude to profit from in-plant training.

Information from District banks indicates that credit demands are stronger than seasonal. Business loans have risen much faster since early November than in the comparable period of any recent year, reflecting gains distributed over a wide range of industries. Moreover, most of the banks participating in the new loan commitment survey expect takedowns on outstanding commitments to increase moderately in the current quarter. Only one said commitment policies have become more restrictive.

So far, however, the banks appear to have met demands without a great deal of strain, and borrowing at our window has been light. The large banks have continued to acquire a substantial volume of funds in the Federal funds, CD, and Euro-dollar markets. In addition, they have reduced their holdings of U.S. Government securities and have some room to make further adjustments here.

Growth in aggregate monetary and credit measures so far this month again appears to be exceeding estimates made at the last meeting and has continued much faster than appropriate if we hope to achieve moderation in activity and to reduce price pressures. Events of recent weeks have brought into sharp focus the serious effects of both past and expected price inflation on wage and salary negotiations and the implications of large

> increases in labor costs on future price trends. With almost no firm indications that the economy is weakening, additional restraint is needed. Even assuming some weakening will develop after the first of the year, monetary expansion at current rates is unnecessarily high.
>
> The rise in market yields since the latest prime rate adjustment may, of course, slow bank credit by shutting off sources of CD money. To the extent that higher rates are seasonal or reflect the reduction of speculative positions in securities due to changed expectations about rate trends, these effects may be quite temporary. On the other hand, the way business prospects look now, private credit demands plus State and local government needs may continue to strain resources into the early part of next year and cause problems with Regulation Q ceilings.

Mr. Scanlon added that he thought the System should increase monetary restraint through action that would clearly convey its intent to fight inflation more vigorously. An increase in the discount rate could serve that purpose. More important, the Committee should aim for a slower growth in credit and money, permitting market rates to find their own level within that framework; no more reserves should be provided through the net effects of open market operations than would yield a 3 per cent growth rate in total reserves. Severe or abrupt changes in market conditions should, of course, be prevented.

Mr. Scanlon indicated that alternative C of the draft directives was acceptable to him. He would favor the more direct and forceful language suggested by Mr. Mitchell, but only if such language fully reflected the Committee's policy intentions.

Mr. Scanlon noted that at their meeting last week the directors of the Chicago Reserve Bank had debated at length whether to propose a 1/4 or a 1/2 percentage point increase in the discount rate. They felt that a 1/2 point increase was desirable from the standpoint of domestic economic considerations, but they recognized that such an increase would place Q ceilings under additional pressure. They also had hesitations with respect to the international effects of such a move. Several directors who were connected with businesses having substantial investments in Great Britain observed that if it were true that the pound parity would stand or fall depending on whether the System raised the discount rate by 1/4 or 1/2 point, the chances were that it would go to a floating rate in any event. The directors thought that the Federal Reserve should be concerned about the international effects of its actions but that it should not overdo such concern. They felt that a 1/4 point increase not accompanied by other firming actions might have to be followed by another modest increase, partly because market participants had already discounted a 1/4 point rise and some were expecting a larger move.

On balance, Mr. Scanlon said, he would favor a 1/4 point increase in the discount rate accompanied by the announcement of a modest increase in reserve requirements. He thought that if the

reserve requirement change was not announced in conjunction with the discount rate increase, there might be a perverse effect on market expectations. He agreed with Mr. Brill that current Q ceilings were exerting pressure on banks. As the latter had implied, however, banks were in a more liquid position to meet such pressure than one or two years ago.

Mr. Galusha remarked that his earlier confidence that the pace of growth in real GNP would decrease significantly had been shaken by recent developments. While he had not entirely given up hope for some moderation, he felt that increased monetary restraint would be appropriate. He favored a 1/4 point increase in discount rates to 5-1/2 per cent, coupled with a modest increase in reserve requirements. He would urge, however, that the Committee proceed cautiously, at least for a time. The Federal Reserve should signal its concern, but not by forcing market interest rates appreciably higher.

A 1/4 point increase in discount rates had apparently been largely discounted in the market, Mr. Galusha observed. If discount rates were increased, even modestly, short-term rates might not decrease seasonally as much as they otherwise would. But that would, he believed, be all to the good. With even a modest increase in reserve requirements, market rates could go higher. The Manager might, however, let the effects be felt

only very gradually. Signaling its concern, but without forcing market rates sharply higher, should therefore be easy enough for the System to manage.

There had already been a rather impressive increase in market interest rates, Mr. Galusha continued. If it were for him alone to decide he would have the Manager maintain the current three-month bill rate within a narrow range around 5.90 per cent. He would have the Desk resist any pronounced tendency for that rate to increase, just as he would have the Desk resist any pronounced tendency for the rate to decrease, even seasonally. There was considerable risk, it seemed to him, in letting short-term market rates go significantly higher, as well as significantly lower. Banks were prepared--in some measure, anyway--for a run-off of CD's. But if short-term rates went much higher, the reaction could be extreme.

Mr. Galusha said he had not yet been able to rid himself of the feeling that consumers were going to respond to increased income taxes in the first quarter of next year. If they did, businessmen could be badly embarrassed by all the additional capacity they were hurrying to install. Conceivably, the Committee might be viewing the economy this morning from near the peak of a boom. He was not confident that such was the case, but he did not dismiss the possibility as wildly remote.

Mr. Galusha added that the directors of the Minneapolis Reserve Bank shared his uncertainty about the economic outlook. That had been apparent at their last meeting, less than a week ago, particularly in their discussion of the discount rate. They had voted to continue the present 5-1/4 per cent rate mainly because they thought that a 1/4 point increase would not accomplish any worthwhile objective unless accompanied by some other firming action, and that a 1/2 point increase would be too large and totally disruptive.

Mr. Galusha commented that the approach involving several policy instruments discussed by Mr. Brill today had considerable appeal, especially in the cautious use of each tool viewed separately. He agreed with Mr. Sherrill that the Regulation Q ceilings represented the fixed jaw of the vise against which the System had to exert its tightening action on banks and, through them, on the business community. The availability of funds, not signals or rates, was the key consideration. If businessmen could obtain the funds, it would be very hard for them to postpone programmed expenditures in the current inflationary environment.

Mr. Galusha concluded by noting that he favored alternative C of the draft directives. As he had indicated, he would want the Manager to resist a decrease, even seasonal, in the bill rate. He would not mind if, in consequence, the Federal funds rate averaged somewhat more than 6 per cent.

Mr. Swan observed that he found himself in general agreement with Mr. Galusha. The continued strength in the economy and the larger than desired growth in bank credit called for tightening despite the possibility of a reversal of seasonal pressures in the period ahead. As had already been noted, the question was not whether to firm but how much and by what means.

Mr. Swan noted that he favored alternative C for the directive. He thought there was much to be said for deleting the word "somewhat" from the second paragraph, as Mr. Mitchell had suggested. Such a deletion would not necessarily imply targets for money and short-term credit market conditions different from the blue book specifications for the firming alternative, but it would help clarify the Committee's intent to make a definite change in policy.

At the same time, Mr. Swan said, he would favor a discount rate increase of 1/4 rather than 1/2 of a point, despite the possibility that the smaller increase had already been discounted by the market. In his judgment a 1/4 point increase was likely to have some significant announcement effect if it were accompanied by definite firming action through open market operations. He certainly thought that the Regulation Q ceilings should not be raised at present. He hoped that circumstances would not arise in the near term that required an increase in the ceilings and

that, if such an increase proved necessary, it would be made reluctantly.

Mr. Swan added that a case could be made for a modest increase in reserve requirements, if the System's move toward firming needed additional support. He would prefer to delay such action, however, until there had been a chance to assess the market's reaction to the discount rate change and the firming through open market operations. In his judgment there would still be time, prior to the turn of the year, to announce a reserve requirement increase with a mid-January effective date.

Mr. Coldwell said he would omit the remarks he had prepared on District and national economic conditions and turn directly to policy. His conclusion was the same as it had been at the preceding meeting--namely, that firming was needed. With respect to open market operations, he favored alternative C for the directive, with the word "somewhat" deleted as Mr. Mitchell had suggested.

A 1/4 point increase in the discount rate would be acceptable to him in the present circumstances, Mr. Coldwell continued. However, in his judgment the visibility of such action, by itself, would be too low; he would much prefer the simultaneous announcement of increases in both the discount rate and reserve requirements. While he recognized that the matter was the

responsibility of the Board rather than the Committee, he hoped that the reserve requirement increase would apply to time and savings deposits and that it would be made effective before the mid-January date that had been suggested.

The choice between time and demand deposits for the increase in reserve requirements was an important one, Mr. Coldwell remarked. He thought the Committee had a smaller than desirable degree of control over the rates of expansion in aggregate deposits and bank credit because reserve requirements were so much lower on time than on demand deposits; as a result of the larger multiplier in the case of time deposits, a given rise in reserves could support much more rapid growth of total deposits when the expansion was primarily in time rather than in demand deposits. An increase in the requirements on time deposits would lessen that problem. Also, by making CD's less profitable to banks, it was likely to encourage some disintermediation, which he thought would be desirable at present.

Mr. Coldwell added that he favored making the reserve requirement increase effective before mid-January partly to obtain a more rapid reaction at all banks than could be hoped for through tightening open market operations. The impact of such action could be moderated by the Desk's operations. In any case, open market operations could be shifted from the reserve-absorption

side to the reserve-supplying side, which would help moderate bill rate pressures.

Mr. Morris remarked that the monetary policy of the past few months had been based on an expected pattern of economic developments that had not been realized and that was not likely to be realized in the months immediately ahead. Since the System had misjudged the strength of the economy, its policy had been excessively expansionary. He thought the System would have to be alert this coming spring to make sure that it was not whipsawed into an opposite sort of mistake. However, he believed that at this meeting the Committee had to recognize the current excessive business strength by moving to a policy which would slow substantially the rate of growth of bank reserves and the money supply.

In the present context, Mr. Morris continued, the way in which such a policy change was implemented was all-important. It should not be implemented abruptly or in a manner that would generate a panic response from the market. Ironically, although the Federal Reserve had not placed any real pressure on the banking system since early June, the recent alignment of short-term money rates with CD ceiling rates had placed banks in a position in which even a modest change in policy, abruptly applied, could produce severe pressure on them. It was important in that sort of situation not to give the market the impression that the Federal Reserve was over-reacting to a past mistake.

Mr. Morris believed that the proper strategy for implementing a more restrictive policy at present was to control the post-Christmas decline in short-term money rates, keeping the banks on the verge of massive disintermediation without pushing them over the brink. That, he believed, was essentially the sort of policy described in alternative C for the directive, if he understood it correctly. Such a strategy would be best served, he thought, by an increase of 1/4 point in the discount rate to 5-1/2 per cent plus an increase in reserve requirements, with both actions announced simultaneously. The reserve requirement increase appealed to him not only because of its constructive announcement effect, but also because it offered an important tool for use in slowing the growth in the money supply without putting as much pressure on short-term money rates as would an equivalent action in open market operations.

Mr. Morris thought there was clearly a need for an announcement effect in the present situation, and he would be concerned that the effect of a 1/4 point discount rate change alone would be too feeble. The need was for a slower rate of monetary growth rather than higher interest rates, and he believed that the market would interpret a reserve requirement increase along those lines.

As he had indicated, Mr. Morris said, he favored alternative C for the directive. Both of the changes Mr. Mitchell

had suggested were acceptable to him. Since he believed that a precipitous policy change would be unwise, he thought it was very important that the proviso clause be two-way and that the Manager be prepared to implement it in either direction, depending on bank credit developments.

Mr. Robertson made the following statement:

> Obviously, we are at a critical decision point for the System today. Since we last met, the stream of economic statistics becoming available has looked significantly stronger. More importantly, signs of spreading inflationary expectations have multiplied. It looks very much like inflationary fever is outrunning real economic expansion, moving us into an increasingly unstable situation. Furthermore, these inflationary feelings have pervaded the financial markets, adding to upward pressures on interest rates and credit flows.
>
> Time after time in recent months the System has felt inhibited in how vigorously it could move against these developing pressures. For a while it was the expected onset of fiscal drag that gave us pause, but now, with the benefit of hindsight, that appears to be too little and too late to be adequately effective. At one time or another, even keel financing considerations at home or tense international markets led us to stay our hand. Most recently, the build-up of late-year seasonal pressures on already hard-pressed debt markets led us to proceed carefully.
>
> Even so, we did pull the monetary reins tauter from time to time during this interval--partly through the workings of the proviso clause, whose firming instructions to the Manager we usually confirmed at succeeding Open Market Committee meetings. Reserve availability was moderated somewhat, relative to what it might otherwise have been, and the upward movement of interest rates was thereby reinforced. By now, with market rates so high as to be a serious challenge to the attractiveness of time deposits at banks and thrift institutions, we are beginning to impose a powerful constraint on the further expansion of credit by these institutions.

But all this may not be enough to deal with the current intensity of inflationary attitudes. Perhaps the Federal Reserve needs to take significant and overt action to begin to calm down this ebullience. We are comparatively free to move in that direction today.

To my mind, a quarter-point increase in the discount rate is an essential part of such a move. But this also may need to be buttressed by a moderate increase in reserve requirements, applicable after the middle of January. Such action would round out a package with an unmistakable signal of indisputable strength that the Fed was going to fight this wave of inflationary sentiment. In my view, the only factor which raises a question about the wisdom of these moves is their potential international impact.

Insofar as open market policy is concerned, it needs to be geared to the market conditions resulting from either or both of these actions, depending upon whatever decisions are made by the Board this afternoon. In other words, it should be designed to seek substantially firmer reserve availability and related money market conditions--about as suggested in the blue book in connection with the firming alternative. The language changes Mr. Mitchell has suggested in directive alternative C would be all right with me, but I would also be willing to vote for C in the form I originally proposed. So long as disintermediation does not run so rampant as to trigger the two-way proviso clause on the downside, I think the Manager ought to keep money markets significantly tighter, thereby resisting any seasonal credit easing and pressing down hard on bank credit growth.

This sort of a policy prescription seems to me to be the right way for the System to challenge, responsibly but firmly, the rising inflationary expectations around us.

In reply to a question by Mr. Hickman, Mr. Robertson said he favored an increase in reserve requirements on the grounds that a 1/4 point increase in the discount rate, by itself, probably would have an insufficient impact on market psychology. He had satisfied himself in his telephone conversations this morning that

a reserve requirement increase would not have seriously adverse international implications. He had also received some indications this morning that some other central banks would be taking firming action shortly, and to his mind that enhanced the importance of System action.

Mr. Hayes said he thought this morning's discussion had been an excellent one. He found it hard to recall a meeting at which the use of all of the instruments of monetary policy had been considered in so thorough and integrated a fashion. While recognizing that responsibility for certain instruments lay with the Board, he believed that today's go-around demonstrated the desirability of using Committee meetings as a forum for such wide-ranging discussions. Particularly since the subject matter of the debate had been so broad, it might be well for him to stress the confidentiality of the Committee's deliberations.

Mr. Hayes then remarked that he would add a word on the subject of possible international reactions to System policy actions. He did not think one could always assess probable international developments on the basis of purely rational considerations; a case in point was the situation in which a politically strong head of state made decisions that ran counter to all economic logic. In any event, it was well to keep in mind that events in the international financial area often followed unpredictable courses.

Mr. Hayes went on to say that Mr. MacLaury had talked by phone with Mr. Coombs this morning about the possible implications for sterling of action by the System to increase reserve requirements. In Mr. Coombs' view, there would be some advantage in postponing the announcement of any reserve requirement increase until the foreign exchange markets were in the doldrums characteristic of the Christmas holiday period. On the other hand, his main concern earlier had been to avoid a timing that might have vitiated the favorable effects for sterling of the announcement of good trade figures for November. That was no longer a concern, and the likelihood was small that there would be some other favorable development in the near future that would suggest postponement of the action. In general, sterling remained on the razor's edge, but the risks involved a great many factors in addition to a change in U.S. reserve requirements. He thought that in the final analysis the System should act in the way best calculated to strengthen the dollar.

As to open market policy, Mr. Hayes continued, it appeared from the go-around that the Committee was unanimously in favor of firming. For the directive, the members seemed to prefer alternative C, as proposed by Mr. Robertson, to the staff's alternative B. Several members had spoken in favor of one or both of the two changes Mr. Mitchell had suggested in alternative C. He (Mr. Hayes) was

sympathetic to Mr. Mitchell's proposal that the word "somewhat" be deleted from the instruction in the second paragraph to seek "somewhat firmer conditions in money and short-term credit markets." He was advised by Mr. Holland that there was a good rationale for that deletion, in that the money market conditions associated with the firming alternative in the blue book involved a more substantial change from prevailing conditions than often had been the case in the past when the directive had called for "somewhat firmer" conditions.

Mr. Daane remarked that if the word "somewhat" were deleted the directive would indicate more clearly than otherwise that the Committee was making a definite change in its policy stance. On that basis, he would certainly favor the deletion.

Mr. Hayes then proposed that the Committee vote on alternative C for the directive, with the word "somewhat" omitted from the second paragraph.

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 over-all economic activity is expanding rapidly and that upward pressures on prices and costs are persisting. Market interest rates have risen considerably further in recent weeks. Bank credit growth has been sustained by continuing strong expansion of

time and savings deposits, while growth in the money supply has accelerated and U.S. Government deposits have declined. The U.S. foreign trade surplus remains very small and the over-all balance of payments apparently worsened in October and November. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging a more sustainable rate of economic growth and attaining reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining firmer conditions in money and short-term credit markets, taking account of the effects of other possible monetary policy action; provided, however, that operations shall be modified if bank credit expansion appears to be deviating significantly from current projections.

It was agreed that the next meeting of the Committee would be held on Tuesday, January 14, 1969, at 9:30 a.m.

At this point, all members of the staff withdrew from the meeting except Messrs. Holmes, Holland, Hackley, Kenyon, Brill, Axilrod, and Broida; and Mr. Harris, Coordinator of Defense Planning, Board of Governors, entered the room. Mr. Holmes reported to the Committee with respect to the Government's investigation of the leak of information on the Treasury refunding of August 1967, and he responded to questions.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

December 16, 1968

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on December 17, 1968

ALTERNATIVE A

The information reviewed at this meeting suggests that over-all economic activity is expanding rapidly and that upward pressures on prices and costs are persisting. Market interest rates have risen considerably further in recent weeks. Bank credit growth has been sustained by continuing strong expansion of time and savings deposits, while growth in the money supply has accelerated and U.S. Government deposits have declined. The U.S. foreign trade surplus remains very small and the over-all balance of payments apparently worsened in October and November. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, continued resistance to inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

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

ALTERNATIVE B

The information reviewed at this meeting suggests that over-all economic activity is expanding rapidly and that upward pressures on prices and costs are persisting. Market interest rates have risen considerably further in recent weeks. Bank credit growth has been sustained by continuing strong expansion of time and savings deposits, while growth in the money supply has accelerated and U.S. Government deposits have declined. The U.S. foreign trade surplus remains very small and the over-all balance of payments apparently worsened in October and November. In this situation, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

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

ATTACHMENT

Projected Change in GNP *
With Alternative Rates of Change in Money Stock
Annual Rates of Change from Previous Quarter

Quarter	Assumed Rates of Change In Money Stock			
1968	0%	2%	4%	6%
IV **	8.3%	8.3%	8.3%	8.3%
1969				
I	5.6	6.3	7.0	7.7
II	4.3	5.7	7.1	8.4
III	1.7	3.6	5.6	7.5
IV	1.1	3.6	6.1	8.5

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* Assumed alternative rates of change in money from IV quarter 1968 to IV quarter 1969. Government spending is assumed to rise at a 5 per cent annual rate.

** Board Staff's estimate in green book, December 11, 1968.