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, October 28, 1969, at 9:30 a.m.

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

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

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

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

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

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

Messrs. MacDonald and Strothman, First Vice Presidents of the Federal Reserve Banks of Cleveland and Minneapolis, respectively
Messrs. Eisenmenger, Parthemos, Taylor, Jones, and Craven, Senior Vice Presidents of the Federal Reserve Banks of Boston, Richmond, Atlanta, St. Louis, and San Francisco, respectively
Mr. Hocter, Vice President, Federal Reserve Bank of Cleveland
Messrs. Garvy and Kareken, Economic Advisers, Federal Reserve Banks of New York and Minneapolis, respectively
Messrs. Bodner and Meek, Assistant Vice Presidents, Federal Reserve Bank of New York
Mr. Willes, Senior Economist, Federal Reserve Bank of Philadelphia
Mr. Sandberg, Special Assistant, Securities Department, Federal Reserve Bank of New York

Chairman Martin noted that since the previous meeting of the Committee the President had announced that he planned to nominate Dr. Arthur F. Burns as a member of the Board for the term beginning February 1, 1970--when his (Chairman Martin's) term expired--and to designate Dr. Burns as Chairman. In this connection, the Chairman caused to be distributed for ready reference copies of the statements that had been issued at the time by the President and by himself.

He had been asked by Dr. Burns, the Chairman said, to indicate that he did not intend to take part in any of the activities of the System or to attempt to influence any of its decisions until after he had been confirmed and had taken his oath of office. By the same token, Dr. Burns would not consider himself necessarily committed by any decisions taken by the System during that period. He might, however, want to visit with members of the Committee and other System officials.

Chairman Martin added that copies of the green and blue books[1/] prepared for this meeting had been sent to Dr. Burns as a matter of information, and that it was planned to provide him also with copies of other staff materials prepared for the Committee during the period before he assumed office.

> By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on October 7, 1969, were approved.
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> The memorandum of discussion for the meeting of the Federal Open Market Committee held on October 7, 1969, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the

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1/ Respectively the reports, "Current Economic and Financial Conditions" and "Money Market and Reserve Relationships," prepared for the Committee by the Board's staff.

System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period October 7 through 22, 1969, and a supplemental report covering the period October 23 through 27, 1969. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said he thought he was revealing no secret when he said that the event for which all of those on the international side had been waiting had now occurred: the German Government had established a new parity for the mark at 3.66 to the dollar, or 27.32 cents per mark. That represented an increased cost of marks to foreigners of some 9-1/4 per cent, a revaluation that exceeded just about everyone's expectations. The markets had reacted very well to the German move and other major countries had already indicated that they would maintain their present parities. The unwinding of positions had begun with a substantial outflow of funds from Germany and the Netherlands, some money moving into the United Kingdom, and a firming in the exchange rates for the French franc and Italian lira.

Mr. Bodner commented that toward the end of last week, as the market began to revise upward its expectations as to where the new German parity would be set, there was increased speculation on the possibility of upward adjustments by several other European countries. Pressures focused particularly on the Dutch guilder, but there was also some flow into Belgium and Austria. At the same time, the flow of funds out of Germany tapered off as the market premium of about 7-1/4 per cent did not seem so attractive when people began to think of a revaluation of 8 per cent or better. Over the past weekend the Dutch and the Austrians had issued statements that they had no intention of making adjustments in their rates, and those statements appeared to have been accepted by the market. The Belgians, on the other hand, indicated they were still considering what to do and there was a large flow of funds into Belgium yesterday. Subsequently the Belgians, too, said they would make no change in their parity, and today the flows had begun to reverse. All in all, the picture at the moment was one of relatively orderly markets settling down to the new situation. Although he hesitated to make forecasts, it seemed not unreasonable to hope that there would be a period of relative calm ahead.

It might be useful to review briefly the experience of the past few weeks, Mr. Bodner observed. As the Committee was aware, the German Federal Bank had operated throughout the period of the floating mark to keep the market stable and orderly by providing a firm floor just below current market quotations. Over the entire period during which the rate was permitted to rise, the German Federal Bank sold some $1 billion in the process of preventing any slippage. Thus, it returned to the market about two-thirds of the funds that had come in during September.

Those tactics were useful in several respects, Mr. Bodner said. In the first place, by preventing significant fluctuations in the mark rate they lent an air of stability to the market that helped considerably to reduce the widespread nervousness that had been occasioned by the abandonment of the previous intervention levels. In addition, the sales of dollars helped to prevent a squeeze in the Euro-dollar market in early October when U.S. banks were increasing their borrowings while funds were moving into several other European centers. The sharp rise in the mark rate quickly made further speculation in marks unattractive and, on the contrary, encouraged liquidation of mark positions.

As he had noted at the last meeting, Mr. Bodner continued, the rise in the mark rate lent some strength to sterling and to the Belgian franc and it brought some speculation in guilders. The guilder was widely seen as the most likely candidate for revaluation in company with the mark, and over the past few weeks there had been a steady flow of funds into the Netherlands. In the final three days of last week in particular, the flow was very heavy; the Dutch took in $360 million, bringing their total gains for the month to $770 million. After repaying outstanding drawings to the System, the Dutch rebuilt their dollar position and then sought cover for the remaining inflow. The System drew the entire $300 million available under the swap line, but that still left the Dutch with $200 million of excess dollars. The additional cover was provided by the Treasury in the form of a one-week swap. The Treasury took the position that in the circumstances it would like to await this week's developments before committing itself for a longer period. Thus far this week, the Dutch had sold nearly $100 million as the speculative flows were beginning to be reversed.

As far as the other currencies were concerned, Mr. Bodner remarked, the pattern in the market had been very much as indicated by the initial reactions to the German move at the end of last month. Belgium made persistent modest gains and over the period succeeded in acquiring sufficient dollars to liquidate fully its $184 million outstanding drawings from the System. As he had indicated earlier, the flow into Belgium continued yesterday but it was beginning to unwind today. The British also gained reserves steadily throughout the month, and those gains had totaled some $385 million. The British repaid $25 million to the System and $75 million to Germany last week, and tomorrow would be repaying a further $75 million to the System and $25 million to Germany. They planned to repay a further $100 million to the System on Thursday. That would reduce their swap drawings from the System to $900 million. The $100 million repaid to Germany this month was part of the $250 million recycling credit given by the Germans in May.

Mr. Bodner reported that two countries, France and Italy, had continued to lose reserves during this period, but in both cases losses were smaller than last month and during the last week both countries were able to pick up some dollars. Nevertheless, the situation in both countries remained uncomfortable and represented the major dark cloud on the horizon--except for the U.S. position, which was quite clearly bad and did not appear likely to improve significantly next year.

In the private gold markets, Mr. Bodner continued, there had been a persistent decline in price throughout the period and last week the London fixing got down to $39.95, the lowest since last December. There had been a slight firming since then because of the Middle East flare-up, but turnover remained modest. On the official side there had been almost no transactions until today, when Ireland sold the Treasury $19 million in gold. The U.S. gold stock remained unchanged, of course, while the Stabilization Fund's holdings now stood at about $820 million.

Finally, Mr. Bodner remarked, he might say a word about the Euro-dollar market, in which there had been a significant decline in rates since the last meeting of the Committee. At that time rates had been running around 10-5/8 per cent for maturities of one to six months, but thereafter rates had declined steadily and yesterday the three-month rate, for instance, was 8-11/16 per cent. That decline reflected a combination of factors. In the first part of the period the dollar sales by the German Federal Bank had kept the market fairly well supplied despite the fact that U.S. banks were increasing their borrowings. More recently, U.S. bank takings had dropped off sharply and that, coupled with a downward shift in expectations about the future course of rates, seemed to account for the further sharp decline. Today, however, U.S. banks were again actively bidding for Euro-dollars and the three-month rate had moved up sharply to about 9-5/16 per cent.

Mr. Bodner concluded by noting that at the last meeting of the Committee the staff had been asked to prepare a memorandum reviewing the forward lira commitments of the Treasury. That memorandum was in preparation and would be distributed to the Committee soon.

Mr. Daane commented that he was hopeful that the situation in the market for Dutch guilders was settling down, as developments yesterday and today apparently indicated. He asked what measures might be taken if that turned out not to be the case and there was a renewed inflow of dollars to the Netherlands.

Mr. Bodner replied that the probable nature of such measures was not clear at the moment. The Treasury had taken the position that it would be appropriate for the Netherlands Bank to increase its holdings of uncovered dollars beyond the $200 million it presently was prepared to hold. The Treasury had been willing to make the one-week swap as a temporary measure partly because it was thought possible that the situation would unwind this week, but also to provide time to discuss with the Dutch the question of increasing their holdings of uncovered dollars. He had advised the Dutch earlier in the week of the Treasury's attitude, and he noted that Under Secretary Volcker would be in the Netherlands this week and no doubt would talk with them about the subject. He (Mr. Bodner) believed the Treasury had not yet reached a decision about the course it would follow if the Dutch should indicate that they were not prepared to hold more than $200 million.

In reply to another question by Mr. Daane, Mr. Bodner said the legal situation with respect to increased dollar holdings of the Netherlands Bank was a little cloudy. However, he understood that officials of that Bank had made a firm commitment to their directors that they would not increase their uncovered dollar holdings beyond $200 million without the directors' express approval.

Mr. Brimmer noted that the System had drawn the full $300 million available under its swap line with the Netherlands Bank. Given the Treasury's attitude that the Dutch should be prepared to hold more than $200 million in uncovered dollars, he hoped the System was not placing itself in conflict with the Treasury.

Mr. Bodner said he did not think there was any conflict. The System's drawings on the Dutch swap line had been viewed as consistent with the kinds of instructions the Committee had given to the Desk from time to time on the use of the swap lines, and no objections to the drawings had been raised by the Treasury.

Moreover, he personally felt that the use of the swap line in the prevailing circumstances was entirely appropriate, since it had been necessitated by a type of speculative flow which the swap network was intended to cope with. When the System swap line had been exhausted the Treasury had agreed to extend a one-week swap of its own while the question of any further action was being considered. At no point had anyone suggested that the System should increase the size of its line with the Netherlands Bank. In any case, in view of the outflows from the Netherlands this week, the question of possible further steps might well be moot shortly.

> By unanimous vote, the System open market transactions in foreign currencies during the period October 7 through October 27, 1969, were approved, ratified, and confirmed.

Mr. Bodner then noted that seven swap drawings by the Bank of England totaling $725 million would mature in the period from November 10 to December 3, 1969. As he had indicated earlier, by Thursday the total amount outstanding under the British swap line would be reduced to $900 million. That was some $75 million below the level at the end of June and $225 million below the level reached after the French devaluation. The Account Management had kept consistent pressure on the British to make maximum repayments, and it felt that in general they had devoted as much of their resources as possible to repayments to the System. As the Committee was aware, the British swap line had been in continuous use since

June 1968, well over the one-year limit, so the Committee's express authorization was required for renewals of the drawings in question. As to the individual drawings, most would involve first or second renewals. One would involve a fourth renewal, but he would hope that that drawing would have been liquidated by the time it matured on November 20. In general, however, it clearly would take some time before all of the British drawings could be repaid and he recommended renewal of the seven drawings at their maturity dates if the British were not in a position to repay them.

Mr. Hayes commented that in a conversation with Dr. Blessing of the German Federal Bank he had noted the very large size of the Bank of England's debt to the System and had expressed the hope that the Germans would not press for an undue proportion of any repayments the British might be able to make. Dr. Blessing was sympathetic to the view--a fact that Mr. Hayes thought might have had some bearing on the size of recent and expected repayments of British debt to the System.

By unanimous vote, renewal for further periods of three months, if requested, of the seven swap drawings by the Bank of England maturing in the period November 10 to December 3, 1969, was authorized.

Mr. Bodner then noted that nine of the System's swap arrangements would mature on December 2 and the others would mature on various dates later in December. He recommended that the Committee approve renewal of all outstanding reciprocal currency arrangements for further periods of one year.

By unanimous vote, renewal for further periods of one year of the following swap arrangements, having the indicated amounts and maturity dates, was approved:

Foreign bank	Amount of arrangement (millions of dollars)	Maturity of latest authorized renewal
Austrian National Bank	200	December 2, 1969
National Bank of Belgium	500	December 22, 1969
Bank of Canada	1,000	December 30, 1969
National Bank of Denmark	200	December 2, 1969
Bank of England	2,000	December 2, 1969
Bank of France	1,000	December 26, 1969
German Federal Bank	1,000	December 16, 1969
Bank of Italy	1,000	December 30, 1969
Bank of Japan	1,000	December 2, 1969
Bank of Mexico	130	December 2, 1969
Netherlands Bank	300	December 30, 1969
Bank of Norway	200	December 2, 1969
Bank of Sweden	250	December 2, 1969
Swiss National Bank	600	December 2, 1969
Bank for International Settlements:		
Dollars against Swiss francs	600	December 2, 1969
Dollars against authorized European currencies other than Swiss francs	1,000	December 2, 1969

Chairman Martin then invited Mr. Brimmer to bring the Committee up to date on the status of proposed revisions in the Federal Reserve's voluntary foreign credit restraint program.

Mr. Brimmer said he had been hopeful that revisions in both the Federal Reserve program and the program for controlling foreign direct investment administered by the Commerce Department would be announced by the end of this week. However, as of late yesterday that schedule no longer appeared feasible, mainly because the Commerce Department had not resolved a basic question as to whether preference should continue to be given under its program to direct investment in developing countries. As far as the Federal Reserve program was concerned, it was planned to retain priorities for loans to developing countries.

The main change planned in the Federal Reserve program, Mr. Brimmer continued, was the introduction of two different types of ceilings. One was a so-called "General Ceiling," equal to 90 per cent of each participating bank's old lending ceiling and available for loans of any type or maturity. In addition, an "Export Term-Loan Ceiling" would be introduced, equal to 1 per cent of the participating bank's total assets at the end of 1968 and applicable to term loans to finance new U.S. export credits to any part of the world, including Western Europe. Export term loans would be defined as they were for purposes of the interest equalization tax. The aggregate General Ceiling would be about $9.1 billion--$1 billion less than the old ceiling; the Export Term-Loan Ceiling would aggregate about $2.4 billion, for a combined total of about $11.5 billion. Under the revised program a few banks would find themselves over their general ceilings, which would continue to be applicable to short-term export financing. It seemed reasonable to give such banks 12 months to bring their holdings down to the ceiling, and it was planned to ask them to reduce any overage by about one-fourth in each calendar quarter.

Mr. Brimmer said he personally was still not convinced that changes in the program were needed to foster U.S. exports. However, there had been considerable pressure from various agencies of the Government to make modifications for that purpose. The revisions he had described had been worked out partly because, in his judgment and that of others associated with the effort, if no concessions were made to the views of other agencies there was a risk that the decision would be made to exempt export credits entirely from the VFCR program.

Mr. Brimmer noted that Chairman Martin and Mr. Daane had been quite helpful in the course of the recent inter-agency discussions. The Board was planning to review the proposed changes at a meeting this afternoon. Reserve Bank officers charged with responsibility for administering the program had been invited to a meeting at the Board tomorrow to discuss the subject.

In a concluding observation, Mr. Brimmer said the Commerce Department was planning to take further steps to liberalize its program. In his view they were going too far toward liberalization, given the outlook for the U.S. balance of payments.

Mr. Daane noted that the fact that the total of the two new aggregate ceilings exceeded the single aggregate ceiling under the present program by about $1.5 billion did not necessarily imply that the change would lead to a worsening of the balance of payments by that amount.

Mr. Brimmer remarked that it was hard to say what the effect of the change would be, partly because it was not clear to what extent banks would shift toward term lending in their export financing. Also unclear was the extent to which banks not in the present program would utilize their leeway under the new program. He was hopeful that participating banks would understand that the objective was to promote U.S. exports rather than to enlarge the volume of export financing, and that all of the leeway under the Export Term-Loan Ceiling would not be used. However, he was not sure that that would be the case.

Mr. Robertson said it might be worth noting that loans by the Export-Import Bank would no longer be exempt from the ceiling.

Mr. Brimmer commented that new loans in three categories--made directly or guaranteed by the Export-Import Bank, guaranteed by the Department of Defense, or insured by the Foreign Credit Insurance Association--would no longer be exempt. However, the exemptions would continue for outstanding loans in those categories.

Mr. Coldwell asked whether estimates were available of the number of banks whose outstanding credits would be in excess of the new ceilings.

Mr. Brimmer replied that no firm estimates were available but it appeared that the number was not large and that most such banks were in New York. As he had mentioned, it had been considered desirable to give such banks a good deal of time to get back under the ceilings. Also, some of their export credits no doubt would qualify under the new Export Term-Loan Ceiling.

Mr. Hayes said he was somewhat puzzled by certain aspects of the proposed program. First, it was not clear to him why banks should be given an incentive to make term loans in their export financing operations in preference to short-term credits. His second question related to considerations of equity. He did not know what the net effect of the new VFCR program would be on the larger banks that had been doing a good deal of foreign lending all along, but if the effect was to increase the degree of restriction on their operations that would seem inconsistent with the changes being made in the Commerce Department program. It seemed to him that in general banks had been more severely restricted than other business corporations, and he would hope that whatever changes were made would not increase the disparity.

In response to Mr. Hayes' first question, Mr. Brimmer commented that the separate ceiling had been restricted to term loans not to provide any particular incentives but simply because of the problems of distinguishing export credits from other types of loans in the general category of short-term credits. Bankers themselves had reported that they would find it difficult to make that distinction and the general conclusion had been that there was no systematic way of identifying short-term export credits.

Mr. Brimmer went on to say that the question of equity which Mr. Hayes had mentioned had been debated at length. It was true that the large banks in New York, Chicago, and San Francisco that had been doing a considerable amount of foreign lending for a long time were still frozen into ceilings related to the 1964 base. However, those ceilings were large enough to permit the banks in question to continue making foreign loans and it seemed equitable to give other banks the opportunity to do so. Moreover, since the assets of the larger banks were substantial, their new Export Term-Loan Ceilings, set at 1 per cent of such assets, also were sizable. Finally, the large banks tended to be those with foreign branches and thus had the flexibility that such branches provided.

Clearly, Mr. Brimmer observed, questions of judgment were involved. However, if one started from the position that no great degree of liberalization in the program was appropriate--as he had--one's conclusions were apt to be in the direction of limiting the magnitude of the changes.

Mr. Hayes said he certainly was not advocating substantial liberalization, since he was a strong advocate of the need for the Federal Reserve program. Rather, his reservations concerned the desirability of incorporating an incentive for banks that had not been engaged in foreign lending to move into the business.

Mr. Brimmer commented that, as he had indicated earlier, the proposed changes in the VFCR program represented a compromise that reflected various kinds of pressures. With respect to

Mr. Hayes' observation, he would note that the Export-Import Bank was anxious to see a considerable increase in the number of U.S. banks engaged in export financing. It was to be hoped that the compromise worked out was one that could win general acceptance and still retain some degree of control over the foreign lending of U.S. banks.

Mr. Daane remarked that he thought there was merit in the observations of both Messrs. Brimmer and Hayes. He and Mr. Brimmer had worked hard to hold down the amount of liberalization of all of the Government's balance of payments programs but, as Mr. Brimmer had indicated, they had achieved only partial success. In their judgment, the U.S. balance of payments position and outlook did not justify any liberalization in either the Federal Reserve program or that of the Commerce Department.

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 October 7 through 22, 1969, and a supplemental report covering the period October 23 through 27, 1969. Copies of both reports have been placed in the files of the Committee.

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

> The bond markets--as the written reports spell out in some detail--experienced a rather dramatic change in sentiment, a change that began about the time of the last meeting of the Committee. There were three distinct

elements in the shift of expectations toward the emergence of lower interest rates: First, a growing belief--sparked by the September unemployment data--that fiscal and monetary restraint was beginning to cool off the economy; second, a strengthening of the hope that settlement in Vietnam was near at hand; and third, a feeling that those favorable economic and military developments would permit--or indeed engender--a relaxation of monetary restraint in the months ahead. In this atmosphere, the markets forgot their earlier apprehension about the heavy calendar of Federal agency and corporate financing and bond prices rose sharply, wiping out the sizable declines that took place in September.

How solidly based the recent rally in the bond markets may prove to be is open to question. Indeed, in the past several days some reaction has set in as the most recent bits of new economic intelligence--on durable goods orders and housing starts--failed to corroborate earlier evidence of a slowing economy, and as Vietnam developments appeared somewhat less hopeful. Thus, it appears that the market atmosphere in the weeks ahead will be very sensitive to unfolding economic developments as well as to shifting hopes for disengagement in Vietnam. While the Treasury will not be a major factor in the market for the rest of the year, heavy demands in the corporate, municipal, and Federal agency markets are apt to maintain pressure on the available supply of new money.

Short-term interest rates have exhibited less dramatic developments, although rates on commercial paper, bankers' acceptances, and Euro-dollars have moved lower. Treasury bill rates have been generally steady despite the auction by the Treasury of $5 billion of tax-anticipation bills. In yesterday's weekly Treasury bill auction average rates of 7.03 and 7.26 per cent were established for three- and six-month bills, respectively, down only 2 to 3 basis points from the rates established in the auction just preceding the last meeting of the Committee. While the Treasury bill market continues to be in a good technical position, some pressures could develop as the result of flows of funds abroad as speculative positions in German marks are liquidated and the German Federal Bank continues to sell bills that it had acquired earlier.

Maintaining relatively steady money market conditions entailed large-scale open market operations over the period, with some form of open market activity taking place on all but one business day in the period. In the first part of the period, with money market banks under considerable pressure, a large supply of reserves was required to prevent the emergence of tighter money market conditions than the Committee had desired. Thus, from October 7 to 17 the System purchased over $1.1 billion in Treasury bills outright--of which over half were from foreign accounts--and made $2.1 billion of short-term repurchase agreements. Consideration was given during this period to purchases of coupon securities, but with prices of Treasury notes and bonds moving sharply upward, we considered it imprudent to add additional fuel to the fire. By Friday, October 17, it appeared that the credit proxy, including Euro-dollars, was turning out substantially weaker than had been estimated at the time of the last meeting, with an annual rate of decline of 11-1/2 per cent projected against a 4 to 8 per cent rate of decline anticipated at the time of the last meeting. Thus, some degree of implementation of the proviso clause of the directive seemed called for and--with the Federal funds rate on the high side--reserves were injected over the weekend. As it turned out, the money center banks accumulated a heavy volume of excess reserves--over $5 billion--over that weekend, and as they subsequently attempted to dispose of them in the market the Federal funds rate dipped below recently prevailing levels. While some easing of tensions in the money market was called for by the weakness in the credit proxy, there were risks that an unopposed easing of conditions might have encouraged the market--on the alert for any signal--to believe that policy had been significantly eased--thereby adding to the upsurge in bond prices. Thus, the System reversed direction and last week absorbed reserves by making over $2-1/2 billion in matched sale-purchase agreements and by selling about $425 million Treasury bills in the market and to foreign accounts.

I might add that by last Friday estimates of the credit proxy for October were back within the range anticipated at the last meeting--although at the deeper end--and with November projections indicating a sizable increase in the proxy, the proviso clause was no longer in effect. Money supply, as you know, was stronger than expected in October, with the estimated rise at about a 2-1/2 per cent annual rate compared with a 2 to 5 per cent rate of decline anticipated at the time of the last meeting. I should note in passing that under the ground rules laid down in Governor Mitchell's memorandum of September 5, 1969, we would have had to tighten up on money market conditions under a short-run money supply target. And, given the disparate movement of the different aggregates from estimates, there would have been considerable confusion about the meaning of the proviso clause if we had been operating under a "basket of aggregates" approach.

With respect to the new authorization for lending Treasury securities held in the System Account, we have continued to work on the detailed operating problems involved but have held up discussions with the dealers in hopes that the Treasury would reach some final decision about its participation. There has been some discussion at the Treasury about direct Treasury lending of securities out of unissued stock, although I would not be very hopeful about the prospects because of legal and other problems. I would be reluctant to wait for the Treasury much longer, and plan to be in touch with the dealers in the next day or so to explain our approach. Our operations can subsequently be folded in with Treasury or investment account activity once the appropriate decisions have been made at the Treasury.

In response to a question by Mr. Robertson, Mr. Holmes indicated that the Treasury was holding back on a final decision to participate in the lending of Government securities pending a thorough investigation of the alternatives. He thought the Treasury would decide against lending securities from its unissued stock in view of the problems with that approach, but the possibility of permitting loans by some Government investment accounts was under active consideration.

Mr. Robertson expressed the view that the lending of U.S. Government securities was primarily the business of the Treasury, and that it would be highly unfortunate if the System were to engage in such lending without the concurrent participation of the Treasury.

Mr. Holmes said he thought it would be desirable for the Treasury to join the System in this activity, since the efficient functioning of the market was a matter of joint concern. However, he believed there still would be compelling reasons for the System to go ahead with lending of securities even if the Treasury decided not to participate.

Mr. Robertson said he recognized the System's interest in the efficient functioning of the Government securities market. He noted, however, that the legal basis for System lending of securities was a finding of necessity. In his view a decision by the Treasury not to participate would raise a serious question about the necessity of such lending by the System.

Mr. Daane remarked that it was the System's own interest in the functioning of the market which had led to the decision to lend securities. While the Treasury also was interested in the performance of the market, he agreed with Mr. Holmes that there were clear and compelling reasons for the Federal Reserve to undertake such lending even if the Treasury did not participate.

Mr. Mitchell noted that the portfolios of the Government investment accounts were not as large or as diversified as the System's portfolio and had been described as inadequate for the lending operation.

Mr. Robertson said that that consideration could be advanced in support of System participation to supplement lending operations by the Treasury. As he had indicated, however, a failure of the Treasury to engage in lending would raise the question of the necessity for the System to do so.

Mr. Hayes said it was his impression that the Treasury would welcome lending operations by the System.

Mr. Holmes indicated that one practical problem associated with the ending of securities by the Treasury trust funds was related to the fact that the portfolios of those funds were divided between special and marketable issues. If the Treasury were to permit the trust funds to lend marketable obligations on attractive terms, there would be pressure to invest more of the trust fund assets in marketable issues and the Treasury would lose some of its flexibility in managing the investments of those funds. There was therefore some reluctance at the Treasury to allow the trust funds to participate in the proposed lending of securities. At the same time, the Treasury appeared to be looking favorably on the possibility of securities loans by such agencies such as the Federal Deposit Insurance Corporation and the Federal Home Loan Banks, whose investments were entirely in marketable Treasury securities.

Chairman Martin said he expected that the Treasury would decide to participate in the lending of securities. In any case, he thought the Committee's action at the previous meeting to authorize such lending by the System Open Market Account had not been made conditional on Treasury participation.

Mr. Hayes concurred in the Chairman's comment regarding the Committee's action.

Mr. Robertson said he thought the Committee's decision had nevertheless been based on an underlying assumption that the Treasury would participate.

Mr. Bopp remarked that the necessity for System lending of securities was a matter of judgment. Since the judgment to be made rested primarily on technical considerations, he thought it was appropriate for the Committee to rely on the recommendation of the Manager, who was in the best position to assess all of the relevant considerations. In his (Mr. Bopp's) opinion, the course followed by the Treasury was not relevant to the Committee's decision.

In response to an inquiry by Mr. Brimmer, Mr. Hackley indicated that in his opinion the only legal basis for System lending of Government securities was a determination that such lending was reasonably necessary to the effective conduct of open market operations and the effectuation of open market policies. He agreed that such a determination involved a matter of judgment which need not depend upon the Treasury's decision about participating in the lending arrangement.

Mr. Heflin said he did not disagree with Mr. Hackley's legal opinion but thought nevertheless that Mr. Robertson had made a pertinent point. Since the views of outside observers regarding the necessity of the lending operations were likely to be importantly influenced by the Treasury's decision, he (Mr. Heflin) thought the System's ability to support the position that such operations were legally authorized would be weakened if the Treasury decided against participation.

Chairman Martin remarked that the Committee could, of course, reconsider the decision it had made at the previous meeting. In any case, it was important that the Manager have a clear understanding of the Committee's wishes in the matter. Perhaps the best course would be to permit the Manager to proceed on the basis of the decision already taken, without attaching conditions regarding Treasury participation, but at the same time advising the Treasury that the Committee would consider it highly desirable for the Treasury to participate.

There was general agreement with the Chairman's suggestion.

Mr. Mitchell noted that at the time of the previous meeting private demand deposits and the money supply had been projected to decline in October, but they now appeared to be growing moderately. While he was pleased by that outcome, he was puzzled as to its cause. Was it the consequence of the marginal implementation of the proviso clause?

Mr. Holmes said he always found it difficult to explain short-run changes in the money stock. One factor that apparently contributed to the October growth was the rapid decline in U.S. Government deposits, but he was not sure that that was the complete explanation.

In response to another question by Mr. Mitchell, Mr. Holmes said the recent shift in market expectations did not appear to have been induced by System operations. Rather, the rally in the bond markets was sparked mainly by changing views about the economic outlook and reports regarding peace prospects in Vietnam. Market participants had long been looking for signs of weakening in the economy and the September unemployment data were widely interpreted as the first significant indication of such weakening. In addition, a large FNMA issue offered in early October--about which there had been considerable apprehension in the market--proved to be a sell-out and that served to engender confidence among market participants.

Mr. Holmes added that the market had tended to view the System's operations over the past month as indicating that there had been essentially no change in policy. Some close observers inferred that a subtle change might have occurred around mid-October, but they were not quite sure. For a few days just after midmonth, when the Federal funds rate had declined to relatively low levels, there was a risk the market would conclude that there had been a significant shift in policy. The fact that the Desk made several billion dollars of matched sale-purchase transactions kept such a view from developing, even though the funds rate was still on the low side.

Mr. Maisel referred to Mr. Holmes' comment that as of last Friday the proviso clause was no longer in effect because the estimate of the bank credit proxy for October was back within the projected range and a sizable increase was projected for November. That statement suggested that the Manager thought the Committee had taken a position with respect to bank credit growth for the two months together. While he (Mr. Maisel) was of the view that the Committee should formulate its preferences for bank credit for periods longer than one month, he noted that the Board staff projections available on Friday had indicated a decline in October at an 8 per cent annual rate and a rise in November at a 7 per cent rate, and thus a negative growth rate over the two months. He could not recall any comments at the preceding meeting suggesting that the Committee thought negative growth was desirable during the period in question.

Mr. Holmes replied that the marginal implementation of the proviso had been suspended primarily because the October projection was back within the 5 to 8 per cent range of decline which the Committee had found acceptable at the previous meeting. As he had indicated, however, the fact that the newly available projection for November showed strength relative to October also had been taken into account.

Mr. Brimmer said he was glad that the Manager had not based his recent operations exclusively on the October projection, especially when the month was nearly over and November projections had become available. Perhaps the recent experience pointed up a problem which the Committee should be looking into.

Mr. Maisel agreed. He added that he was not convinced that the Friday projection of bank credit behavior in October and November together was as strong as had seemed likely at the time of the previous meeting. In any case, he had not meant to suggest that the Desk's operations had been improper. The problem, as he saw it, was that the Committee did not provide the Manager with an adequate basis on which to make his operating decisions.

Chairman Martin commented that he continued to be wary of what he had often referred to as "statisticalitis."

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 7 through 27, 1969, were approved, ratified, and confirmed.

The Chairman then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts and tables have been placed in the files of the Committee.

Mr. Partee made the following introductory statement:

> The time has come once again for the staff to present to the Committee a full-scale review of economic and financial prospects. Early in the game, we decided to develop a projection encompassing the full year 1970, for three reasons. First, fiscal policy is almost certain to become more expansive next year, but a good part of the stimulus may not be felt until the latter half of 1970. Second, monetary policies pursued for the remainder of this year and into early 1970 will have effects on GNP well beyond the middle of next year. Third, much of the basis for the continuing strong bullish sentiment of businessmen and investors rests on the premise of a "hill on the other side of the valley" and we need to have a judgment as to how steep that hill may be.
>
> I must emphasize that this is only a first look at 1970--and it is fraught with uncertainties. The Federal Budget for fiscal 1971 is still in the formative stage, and we can only guess at its eventual dimensions. What happens with regard to the Vietnam conflict will obviously be of major importance, and the rumors flying around these days make it difficult to know just how much of a decline there may be in defense spending to help offset increases in other programs. And from the private economy have come some recent data on housing starts and new orders for durables that are more bullish than anything we had expected.
>
> Given these uncertainties--especially regarding the course of fiscal policy--it seemed to us appropriate to devote even more careful attention than usual to the policy assumptions of the projection.

Mr. Gramley then presented the following comments on the policy assumptions of the projection:

It has been evident for some time now that the maximum degree of fiscal restraint is behind us--the real question is how much stimulus will be coming from the Federal budget. We have assumed Federal expenditures in the current fiscal year consistent with the Budget ceiling of $192.9 billion for total outlays, reflecting the Administration's intentions to remain within this limit and the increasing probability that defense expenditures will decline as earlier expected. The pressures for increased outlays in other areas are intense, however, and should lead to a significant increase in expenditures next year. We expect total expenditures, as measured in the national income accounts, to grow by almost a 9 per cent annual rate in the second half of 1970, compared with about 5 per cent during the past year.

Another uncertainty centers around the timing of the removal of the tax surcharge. We are assuming an extension of the surcharge at 5 per cent through June 30 and elimination thereafter. If the surcharge were to go off entirely on January 1, Federal receipts in the first half of 1970 would be reduced by about $5 billion, annual rate. Either way, however, the economy will face a considerable amount of additional fiscal stimulus next year from lower tax rates.

With expenditures growing and receipts leveling out, the over-all Federal Budget would swing into a moderate deficit after the first quarter, and the deficit deepens in the second half when the surtax is completely suspended. The projected deficit is large, although smaller than in several quarters of 1967.

In addition to adjustments in tax rates, the movement of the budget into deficit in 1970 reflects the projected economic slowdown. This is indicated by the contrast between the NIA surplus or deficit with the high employment budget. The high employment budget abstracts from changes in the rate of economic growth, and it continues to register a small surplus through 1970.

There is already a substantial degree of monetary restraint in force. Growth rates of all the major monetary aggregates showed sizable declines in the first half, and even larger reductions in the third quarter. Growth in total reserves on a three-month moving average basis was deeply negative in the third quarter and has exhibited a weaker performance all year than in 1966. The sizable attrition of negotiable CD's that began early this year was joined during the spring and summer months by a run-off of consumer time and savings deposits. As a result, we have witnessed the longest and deepest decline in total time deposits of the postwar period.

While monetary restraint has reduced the growth rate of the money supply, the relatively high rate of expansion in current dollar GNP thus far in 1969 has sustained demands for transactions balances. Consequently, money supply growth, while moderating, has remained somewhat above the 1966 rate. Total bank credit growth has been lower than in 1966, because of the heavy attrition of time deposits. If adjustments are made for nondeposit funds not reflected in bank balance sheets, bank credit growth in 1969 would still be smaller than in 1966.

Indications of financial pressure are also evident in interest rate developments. Short- and long-term rates in all sectors have advanced through most of this year, and especially in the third quarter--when GNP growth and corresponding credit demands continued strong, while the supply of available funds was severely constrained. Even though expectational factors have induced some decline in rates recently, the effects of mounting pressures in credit markets have begun to be felt throughout all sectors of the economy.

These pressures have fallen with particular force on the banking system. Liquidity ratios have declined materially this year--to levels below those experienced in 1966, not only at New York banks but also at other weekly reporting member banks. With liquidity reduced, the ability of commercial banks to finance additional credit demands has depended increasingly on their success in obtaining nondeposit sources of funds, which have become more difficult and costly to obtain, partly as a result of regulatory actions. Other financial intermediaries, such as thrift institutions and insurance companies, have also experienced growing restraint on their ability to accommodate credit demands because funds inflows have declined, policy loans have advanced, and liquidity positions have deteriorated.

These pressures on financial institutions have begun to affect borrowing patterns in the nonfinancial sectors. Thus, the annual growth rate of corporate bank loans has declined considerably since mid-year. With total investment continuing to advance this summer, the slowdown in bank loan growth to businesses appears to be attributable to effective rationing.

This decline in bank loan growth has not been fully offset by increased dependence on other sources of funds. In particular, market borrowing, including issues of commercial paper as well as bonds and stocks, also declined a little in the third quarter. Consequently, total borrowing of the corporate sector has fallen this summer, and liquid assets have been drawn down.

State and local governments have been more severely affected by increased monetary restraint. Long-term borrowing by these governmental units has declined sharply this summer in response to higher interest rates, and short-term borrowing has dropped even more from the exceptionally high rate earlier this year--perhaps partly in response to reductions in available bank funds. Total borrowing, consequently, has fallen markedly. It seems likely that State and local governments have been forced to re-evaluate and reduce their capital spending plans in response to these financial problems.

In considering an appropriate set of policy assumptions for the future, we have tried to take into account the continuing effects of restraint in the nonfinancial sectors that has resulted from tighter monetary policies during 1969--as reflected in the behavior of total reserves, money supply, time deposits, and bank credit. Our policy assumptions, however, call for only a gradual move toward less restraint--and one that does not begin until after the turn of the year, when the nature of the economic adjustment that now seems in prospect will be clearer.

Because the less restrictive posture of monetary policy is assumed to begin in the first quarter of 1970, total reserves are projected to decline a little in the last quarter of this year. Growth in total reserves is resumed at about a 2 per cent rate in the first half of 1970 with the rate advancing to about 4 per cent in the second half of the year.

With the gradual change in policy assumed, total time deposit growth would remain relatively small in the first half of next year, since market interest rates in the first quarter would still average near current levels. Thereafter, time deposit growth should pick up, since projected GNP growth is slower, and interest rates should decline in response to this and the larger reserve additions. Growth in money supply also would be expected to pick up a little in the first half, and then rise to about a 4 per cent rate in the second half of the year, when projected reserve injections are a bit larger.

On the asset side, we would expect bank credit--measured on an end-of-month basis--to correspond closely to the projected increases in deposits. Thus, bank credit growth might increase gradually to about a 5 per cent rate in the second half of 1970. Given projected economic developments, we would not expect banks to face loan demands sufficient to generate large inflows of Euro-dollars or other nondeposit sources of funds reflected on bank balance sheets.

The moderate path of monetary and credit expansion envisaged is characterized by projected developments in the CD market. Yields on 3-month Treasury bills, given our GNP projection and our assumptions about reserve growth, might decline to a range of 6 - 6-1/4 per cent by mid-year. On the assumption that CD rate ceilings are unchanged--an effort at realism rather than a staff preference--the relationships between market yields and CD ceilings would likely lead to a continued run-off of outstandings through the first quarter of next year. Thereafter, only very modest growth in outstandings would be expected--with the level by December 1970 only a little higher than at present.

We have also assumed unchanged Regulation Q ceilings on consumer-type time and savings deposits, so that growth in these claims would respond mainly to developments in market security yields. Growth in consumer deposits at banks--that is, all time and savings deposits other than CD's would resume, but the rate of growth would be barely above zero in the first half of next year, since first-quarter gains would be held down by outflows during the January interest-crediting period. The projected gain in the second half also is relatively small, reflecting the limited decline expected in market interest rates.

Growth of nonbank savings accounts is likely to follow a similar pattern. With rate ceilings unchanged, inflows to thrift institutions should resume after the January reinvestment period and increase gradually over time as market rates decline.

These policy assumptions seem to us a cautious approach to resumption of expansion in the monetary and credit aggregates. We turn now to the analysis of nonfinancial developments that might emerge with this projected course of policy.

Mr. Wernick made the following comments on nonfinancial developments:

The bite of monetary and fiscal policy has become evident in many indicators of economic activity. Retail sales growth has continued sluggish, lending credence to the findings of recent surveys that consumers are restricting their purchases because of concern about higher prices, tight money, and future prospects. The two-month dip in industrial production in August and September reflects an important change in the thrust of the economy and is in sharp contrast to the 6 per cent annual rate of increase earlier this year.

The trend in unfilled orders for durables has remained fairly level in recent months, and seems to be in line with a moderation in economic activity. Meanwhile, employer hiring decisions have apparently begun to respond to weakening demands, and growth in nonagricultural employment has slowed appreciably this summer.

With monetary policy assumed to remain very restrictive into early 1970, current indicators seem to imply a decline in GNP growth over the next few quarters. The critical questions are how much and for how long? We anticipate that in the first half of next year, gains in final sales will be appreciably lower, and inventory investment will be weaker, than in the third quarter of this year. Dollar gains in GNP should taper off to about $7 billion, and real growth probably will be at or below zero.

After midyear, GNP growth is projected to pick up again. Consumer buying should be buoyed by tax cuts and a Federal pay increase, while housing starts will be turning up as funds become more available. We think that real growth can be held to moderate proportions, rising perhaps to 3 per cent by year's end. This would be somewhat less than the expected growth in resources, and it would imply some easing in pressures on costs and prices.

The principal factor pointing to a stronger second half is the likelihood that Government spending will become more stimulative. The higher spending totals, however, are not likely to appear in Federal purchases of goods and services. In fact, Federal purchases are anticipated to resume a downward trend this quarter and to decline further until mid-1970 as defense spending is curtailed. A civilian and military pay raise in the third quarter of next year would raise these purchases somewhat.

But in all probability other NIA expenditures will be increasing much faster next year. The projected step-up reflects increased social security benefits, higher costs of proposed and current welfare programs, and growth in such noncontrollable items as interest and veterans payments.

State and local government capital expenditures will probably be limited in the coming year by high interest rates. However, other State and local government purchases will continue to increase, and the total would thus rise only a little less rapidly than during the past year.

High borrowing costs and limited supplies of available funds have already cut housing starts by almost one-fourth. Despite the September rise, we think housing starts are likely to continue to recede, perhaps to an annual rate of 1.0 million units in the spring. Important factors in this assessment include the low level of savings inflow to mortgage lending institutions, the probability of large outflows in January, and the fact that builders and buyers will increasingly resist high interest rates. As funds begin to become more readily available next spring, starts should turn up. But we foresee only a moderate rise at first, reflecting the usual lag as builders gear up.

Residential expenditures will lag further behind, so that our starts projection would not bring any significant upturn in GNP expenditures before the final quarter of the year.

While housing outlays have been in a declining trend, business fixed expenditures have continued to rise steadily this year. However, output of business equipment has begun to level off recently, and new orders for machinery and equipment were drifting downward prior to the sharp jump in September, which was due in part, apparently, to special factors.

We expect only modest further increases in business fixed investment expenditures in this and the coming quarter, in line with the Commerce-SEC survey. Thereafter, with the growth in final demands projected to level off, the investment tax credit eliminated, and profits declining under strong upward cost pressures, it seems doubtful that earlier plans to increase business investment spending will be realized. We are projecting expenditures to remain level after the first quarter, implying a year-over-year increase of about 4 per cent.

Growth in consumer expenditures has already slowed, despite substantial gains in disposable income. Much of the easing in total expenditures affected durable goods purchases, with sales of appliances, furniture, and other household durables noticeably weaker.

The reduction in the surcharge to 5 per cent in January and higher social security benefits in April should tend to support disposable income and consumption in the first half of next year. But shorter workweeks and more limited employment gains are expected to be dampening factors. We would thus expect a rise of only modest proportions in consumer expenditures, with durable goods sales continuing weak.

After midyear, disposable income should climb more strongly with the elimination of the surcharge, another boost in Federal pay, and a rebound in output. But this should have limited effects on consumption, since a moderate rise in the savings rate seems probable with the surtax off. The 6.7 per cent savings rate we are projecting for the second half would be less than in other recent years prior to the surcharge.

Partly because retail sales were sluggish, inventory investment increased last quarter. The ratio of durable goods inventories to unfilled orders, a fairly reliable indicator of excessive inventories, has risen significantly, and is now higher than in late 1966.

In the current quarter there may be some unintended stock-building, which will increase the probability of a decline in inventory investment early next year. The slowing we have projected over the year is more modest than in most earlier inventory adjustments, in part because the projected reduction in real output is small and business confidence in future prospects apparently continues strong. Nevertheless, the slower pace of inventory accumulation would result in cutbacks in industrial production and employment in the first half of next year.

Growth in employment has already moderated. With industrial employment projected to decline and other sectors showing less strength, employment gains should continue weak through the first half of next year. In fact, we would also expect employment gains to remain relatively small in the latter half of the year since productivity gains usually accelerate as output picks up.

A marked easing in employment in the past has been associated with a slower growth of the labor force.

Next year, the labor force is anticipated to increase at about a 1.5 million rate--less than the very sharp rise over the past year, but in line with normal labor force growth.

With employment gains smaller than the rise in the labor force, the unemployment rate is expected to rise to about 4.5 per cent by midyear and to about 5 per cent by year end.

Reduced demands for labor, a shorter workweek, and less premium pay should dampen somewhat the increase in average hourly compensation in manufacturing next year. In addition, employer resistance to increased wage costs--reinforced by shrinking profits and weaker markets--should stiffen markedly. But having seen past wage gains eroded by rapidly rising prices, unions are expected to demand even larger wage increases and to strike to get them. On balance, we have assumed that average hourly compensation in 1970 will increase a little less than this year.

For the year 1970 as a whole, productivity gains should also be smaller, as they usually are in years of slower economic growth. With hourly compensation and productivity both increasing a little less rapidly, unit labor costs would continue to advance at about a 4 per cent rate for the year as a whole. But after midyear, as output picks up, productivity gains should be substantially larger than in the first half, and upward pressures on costs and prices should moderate.

For the present, labor and other costs are continuing to climb and industrial prices are moving up at a fast pace. But if business demands and pressures on resources slacken, the advance in industrial prices should gradually slow. We would expect the slowing trend to be more apparent in the latter part of the year, as cost pressures ease. Prices of farm and food products are expected to be more stable next year and to contribute to a slowing in the rise in the over-all wholesale price index.

There is some hope, also, for moderation in the rise of consumer goods prices. In particular, prices of nonfood commodities should respond to the slower pace of industrial prices. Although service prices and the total CPI seem certain to continue climbing at a fast rate, the rise may be slowed somewhat if mortgage interest rates increase less rapidly--especially in the latter part of next year.

On balance, we expect real GNP growth to turn negative in the first half of next year, and then to rise moderately. With pressures on resources easing throughout the year, we would expect a gradual slowing in the rate of inflation, with the increase in the GNP deflator down to about 3 per cent by the end of 1970.

Mr. Hersey presented the following comments on the balance of payments projection:

We have provided you with a table giving our projection of the U.S. balance of payments a year ahead. Every figure in this projection ought to be read as the center of a range of possibilities. With that said, it may be useful to summarize the projection now, before we look at the parts. In brief, comparing 1970 with 1969, we look for a goods and services net export balance better by nearly $2 billion; we expect a small decrease in the net outflow of U.S. Government grants and loans, more than offset, however, by an increase of about $1 billion in net identified outflows of private capital; and we think it reasonable to suppose that adverse payments classed as "errors and omissions" because of lack of information will be about $2 billion smaller. The over-all balance to be financed by Euro-dollar borrowings of U.S. banks and by official reserve transactions would thus improve perhaps by $3 billion, from a deficit of about $8 billion this year to one in a range of $4 to $6 billion in 1970.

We look for improvement in the trade account because one of our basic assumptions is less buoyant demand in the United States than abroad. Demand in other industrial countries for our exports depends greatly on levels of industrial activity. The composite index for other industrial countries, after a slowdown from mid-1966 till a year later--notably in Germany, has recently been rising faster than our index. Beginning in the present quarter, and until late next year, a wide divergence between the trends in activity here and abroad should help to enlarge the U.S. trade surplus.

We are beginning to see the export prices of our chief competitors tilt upward under the pressure of full capacity utilization and rising wage demands. British export prices dropped sharply in terms of dollars through devaluation of sterling in November 1967, but they have risen some since then. Japanese export prices have been moving up since 1966. German export prices, which declined during and after the 1967 recession, rebounded sharply beginning late in 1968--probably reflecting the addition by exporters of the 4 per cent border tax adjustment--and may rise somewhat further now, since the 9 per cent revaluation of the mark amply exceeds the rescinded border tax adjustment. It is abundantly clear, however, that U.S. export prices for manufacturers have been going up recently as fast or faster than the others. When the cooling of the U.S. economy being projected today materializes we may hope for more favorable comparisons.

Given this background, and the encouraging trade figures of recent months, we expect the merchandise export surplus to recover to about $2 billion next year. However, by the second half of 1970 imports will probably again be rising faster than exports, if we can assume that past relationships to the various causal factors continue to apply. Even with reasonable stability in the U.S. economy, further gains in the trade balance would then depend on stronger demand pressures abroad than are now projected, on faster cost and price advances abroad than here, or on additional exchange rate adjustments.

One indicator of the depth of our difficulties in foreign trade is the steeper rise in import buying than in total expenditures in the U.S. economy. At times of setbacks in U.S. demand--as in 1960, or 1967--the propensity to import dips; but the relationship has been shifting upward since 1964. Our projection of a very slow rise in the next few quarters represents a falling below the longer-term trend.

The decline in the goods and services balance to the middle of this year reflected mainly the developments in merchandise trade. Another unfavorable factor was the rise in interest payments on our greatly enlarged borrowings from foreigners, plus dividends on foreign holdings of U.S. equities. Income paid to foreign investors, banks, and central banks is estimated to be $1-1/2 billion more this year than last. Next year such payments would rise much more slowly as interest rates ease down. In the present projection U.S. military expenditures abroad are carried forward at close to the present $5 billion rate.

Projecting capital movements now is difficult because of possible changes in the control programs, uncertainty about trends in the portfolio preferences of foreign investors, and the difficulties of forecasting changes in interest rates and equity markets abroad as well as here. From the latter part of 1967 until early this year we benefited greatly from large inflows of foreign capital to buy the equity and debt issues of

U. S. corporations. Even though the outflow of U.S. capital was large, the net balance of the two flows was inward for about a year. As you know, the inflow of foreign capital for investment in U.S. securities declined abruptly last spring. We look for a gradual increase from now on. On the other hand, the outflow of U. S. capital, though probably shrinking before the year end, is likely to be larger next year.

U.S. manufacturing companies' projections of plant and equipment outlays by their foreign subsidiaries indicate a new surge of capital flow to finance the subsidiaries. It should be noted that our flow projections make no allowance for the loosening of the direct investment control program which seems to be in the cards.

Even without allowing for liberalization, the part of the corporate outflow financed by U.S. funds--that is, after deducting the "Delaware corporation" type of borrowing--is expected to be nearly $1 billion higher next year than in 1969, and $2 billion higher than the 1968 amount. This U.S. funds outflow will be as large as before the mandatory control program--though still low in relation to the rising requirements of the foreign subsidiaries.

For the outflow of U.S. bank credit, we assumed in this projection that the VFCR would not be changed materially and we allowed for only a small outflow. If additional leeway is provided for export credits, a very rough guess is that the outflow might be $1/2 billion larger than we assumed.

Perhaps the most striking feature of the U.S. balance of payments this year has been the massive increase in borrowing of foreign liquid funds by U.S. banks. This inflow has sheltered our reserve position, and even yielded surpluses on the official settlements basis from the second quarter of 1968 through the second quarter of this year. But since July these liabilities have not increased much.

The adjusted over-all balance, which this year has run slightly less unfavorably than the published liquidity balance, sums up the current account plus all capital flows except the Euro-dollar borrowing plus "errors and omissions," which were extraordinarily large in the first half of this year. We think that unrecorded movements of funds into Euro-dollars and German marks in the second quarter may have been at an annual rate around $5 billion. As these outflows subside, and as recorded capital flows and the trade balance improve, the deficit is becoming smaller in the current half year as measured on the liquidity basis or on the virtually identical adjusted over-all basis. Next year, though smaller than in 1969, it will probably still be larger than in any year before 1969. The range of uncertainty is wide, and, I think, may be wider than we have indicated. Even more uncertain is the future of the official settlements deficit. We would need to have a conviction about the direction of change in liabilities to foreign commercial banks before we could decide whether to project this deficit as smaller or larger than the projection of the liquidity deficit.

The massive overhang of liabilities to commercial banks abroad, at a time when the underlying deficit remains very large, creates a danger of a very rapid buildup in foreign official claims against us, should U.S. banks decide, under changing market conditions, to reduce these borrowings considerably. This situation makes it highly important to be able to demonstrate to foreign countries that the United States has not been negligent in efforts to restore stability in the domestic economy.

Mr. Partee concluded the presentation with the following remarks:

Economic projections for as long as five quarters ahead always contain potentially large margins of error. This is especially true of the GNP projection just presented--if it captures correctly the contours of economic developments in 1970. If real GNP growth does fall to zero or a little below in the first half of next year, economic weaknesses in some sectors could spread to others, and carry us into a deeper and more prolonged economic slowdown than we now foresee. This would create strong pressures for remedial action and perhaps undermine the basis for price stability later on.

On the other hand, our projection calls for a resumption of economic growth in the second half of next year. A more expansive fiscal policy than we have assumed, or continuance of the present degree of inflationary psychology in the business community, could add excessively to that rebound. A revival of growth to the degree we are projecting would not destroy prospects for getting inflation under control. But these prospects would be seriously jeopardized if, after a first-half slowdown, real growth were to resume as rapidly as it did, say, in late 1967 and 1968.

Our projection assumes a good deal of additional fiscal stimulus in 1970, especially after midyear, but we have not assumed the worst. If the surcharge were eliminated entirely as of January 1, it would give a very large boost to disposable income in the first half, and would increase the prospects for an early rebound in final demand. And it could be that more dramatic increases in Federal expenditures will develop, especially if the expected decline in defense spending does not materialize.

There are also possibilities for major error in our projection for private spending. Probably the most important is in business fixed investment, which could be either stronger or weaker than we have assumed. Arguing for more strength is the persistence of inflationary psychology, the pressing need to cut costs, the results of two rather fragmentary private spending surveys, and the unexpected upsurge in September new orders for machinery and equipment. But there are equally impressive considerations arguing for greater weakness--including the current and projected trend of final demands, the indicated downdrift in capacity utilization, the tightness and high cost of money, and the probability of a fairly severe profits squeeze. Under the circumstances, I think the projection of no change in expenditures after the first quarter is the better part of valor.

For housing, a strong case can be made for further declines from present levels, given the current state of the mortgage market. But we have no strong convictions as to how far down the bottom is, though it seems certain to occur in the first half of next year, given our policy assumptions. A month or so ago, the outlook seemed so bleak that a drop in starts to around the one million level appeared inevitable. But the upward revisions of starts for August, together with the unexpected rise in September, suggest that there may be a little more life in this sector than we had bargained for.

In the inventory area, on the other hand, the potential weaknesses could be greater than we now expect. Ratios of durable goods inventories to unfilled orders have risen considerably since last spring, and are now above the levels of late 1966 and early 1967. We expect a much smaller adjustment in inventory investment this time mainly because the short-fall in sales is also projected to be small, and because businesses probably will be reluctant to cut back inventories sharply while prices are still rising and a second-half rebound seems probable. But if expectations about final sales and prices were to change materially early next year, the rate of inventory accumulation could fall far more sharply than projected here. This is always a much more volatile sector, looking backward, than one is willing to project ahead.

Another volatile area, at least in its component parts, is the balance of payments. Our projection calls for some improvement next year in the liquidity balance--based mainly on a cyclical recovery in the current account surplus. Monthly foreign trade reports are encouraging, and growth in our imports should moderate with the projected slowdown in the domestic economy. But it should be emphasized that, in the capital flows part of the projection, we have assumed no further easing in Department of Commerce or VFCR restraints. And, in any case, a projected deficit of around $5 billion during a cyclically propitious year underscores the fundamental importance of getting inflation under control.

The case for projecting moderation in both economic growth and in price pressures next year rests fundamentally on the belief that monetary restraints currently in place will be taking their toll in spending. The projected course of monetary policy is, I believe, in keeping with the uncertainties of the situation we face. The resumption of monetary expansion is assumed to be gradual, and growth of the major monetary aggregates next year would remain far below the high rates of 1968. Indeed, the projected rates of growth of some of the aggregates--such as time deposits--would remain below longer-run norms throughout the year, since in the financial environment we are projecting interest rates on market securities would remain very high for a period of economic slack.

The continuation of relatively high market interest rates results, in part, from the growing amount of credit needed by the Federal Government and the Federal lending agencies. Budgetary borrowing on a seasonally adjusted basis should remain relatively small until the second half of calendar 1970. But then the budget will be moving into deficit, and the Treasury will be coming to market for a substantial volume of funds.

Borrowing of Federally sponsored agencies, meanwhile, is projected to continue at relatively high levels in the first half of next year, reflecting mainly support of the mortgage market by FNMA. These borrowings should decline by the latter half of 1970, fortunately, as projected fund inflows to the nonbank intermediaries improve.

In the private economy, over-all credit flows consistent with our projection would not be excessively large, but private security offerings should be substantial. Borrowings by municipal governments, as indicated earlier, have been held down recently by high rates of interest, and these governments should be a major source of sustained credit demands next year. Also, corporate nonfinancial businesses are expected to be relatively large borrowers in the securities markets, as projected spending for fixed investment is reasonably well maintained in the face of a sharp decline in profits.

Given the credit demands projected, and our assumptions about monetary policy, the emerging pattern of financial flows does not seem to be one which would actively stimulate the economy. The share of funds supplied by commercial banks, for example, would rise to only a little more than 10 per cent in the first half of next year, and then edge up to 20 per cent in the final six months.

The major nonbank savings institutions, meanwhile, are projected to show only modest growth rates of deposit accounts, and the increase in their share of total funds raised would be correspondingly small.

Financing the projected GNP, consequently, would require that the nonbank public--that is, businesses, consumers, and State and local governments--continue to be major direct lenders in credit markets by purchasing market securities. Indeed, the projected proportion of total funds supplied by the public in 1970--32 per cent in the first half and 23 per cent in the second--is an amount that historically has characterized a period of substantial monetary restraint.

Consistent with these fund flows is a pattern of interest rate movements--as best we can judge them--which seems to confirm the view that projected credit market developments would not give rise to much stimulus to spending next year. For bill rates, we would expect a decline to the 6 to 6-1/4 per cent range by the second quarter of 1970. There could be a gentle rise in bill rates thereafter, if economic activity picks up in the second half, as projected.

For longer-term interest rates projected declines are even more modest, in line with our expectations that demands for long-term funds will be strong. Indeed, mortgage rates are expected to drift up a little further from present levels, since these rates are always slow in responding to general changes in credit market conditions.

Obtaining the projected rates of interest and the associated growth rates of the monetary aggregates would, at some point down the road, require an easing of money market conditions. Since May of this year, net borrowed reserves have edged down a little while the Federal funds rate has risen moderately, following the sharp run-up in the first five months. But the monetary aggregates and also market interest rates have both been signaling a marked intensification of monetary restraint over this period.

If the economy weakens as we are projecting, holding money market conditions unchanged would mean that we would be operating against the direction of market forces, and this would lower the growth rate of the money supply and other monetary aggregates further. Although consistency with our projection would not require overt policy action at this time to lead the market down, it does presuppose a readiness to accommodate declines in interest rates initiated by the market. Subsequently, more positive steps would be needed to encourage resumption of adequate longer-run growth in the monetary aggregates.

For the moment, however, I would no longer recommend an immediate change in the stance of monetary policy, given the puzzling character of some of the recent economic indicators and the still unknown potential for more fiscal stimulus early next year. For this meeting, I believe that prudence calls for the adoption of the "no change" policy specified in alternative A of the directive.[1/] I still believe that the odds favor further development of economic weaknesses along the lines that we have projected, and I also feel that policy has been and is too restrictive to be viable for very long. But there is enough current uncertainty about the outlook to justify keeping taut pressure on the system for a little while longer, until the near-term outlook comes into sharper focus again.

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

Mr. Coldwell noted that in the staff's projection growth in dollar GNP was expected to fall from an annual rate of over $17 billion in the third quarter of 1969 to about $7 billion in the first two quarters of 1970, and that real GNP was expected to decline slightly in the latter period. He asked whether his understanding was correct that that outlook was predicated largely on expected developments with respect to business inventories.

Mr. Partee replied that developments in most expenditure categories were expected to contribute to the weaker performance of GNP in the first half of 1970. Thus, the projections suggested that plant and equipment outlays would level off, that residential construction expenditures would decline sharply further, that Federal purchases would continue to edge down, and that consumer spending would not be notably strong. It was true, however, that a turnabout in the inventory situation--from sizable accumulation in the third quarter to a more moderate rate of investment in the first half of 1970--was one of the factors underlying the projection of no growth in GNP in the latter period. Moreover, as he had indicated in his remarks during the chart show, the inventory turnaround could well be sharper than implied in the projections.

Mr. Heflin noted that Federal expenditures on goods and services, which had increased at nearly an 11 per cent annual rate in the third quarter, were projected to be declining at a rate of over 8 per cent in the second quarter of 1970. He asked whether that projection was based simply on a staff assessment of information available publicly, or whether it had been possible to get additional information from Government agencies.

Mr. Gramley replied that the projection in question represented the staff's best judgment after discussing prospects for Federal spending, including defense spending, with people in various agencies--particularly the Bureau of the Budget. While the staff had tried to get as much information as possible on the views of people in those agencies, it had felt free to exercise its own judgment when individual figures mentioned seemed to be outside the bounds of reasonable expectation. Particular attention had been given to the question of whether it was realistic to expect budget outlays in fiscal 1970 to be held to the assumed level of $192.9 billion. While there had been some indications that it might not prove possible to hold outlays down to that level, it appeared that defense spending would decline sufficiently so that any excess over that figure was not likely to be great.

Mr. Gramley added that the projection of a considerable expansion in Federal spending in the second half of 1970 reflected anticipated developments with respect to the uncontrollable items in the budget and an expectation of a substantial rise in welfare outlays. It was hard to say just how large the rise would be; the figures shown in the tables were simply the staff's best guess at the moment.

Mr. Partee remarked that in his judgment any errors in the projected rise in Federal spending in the second half of 1970 were more likely to be on the side of understatement than overstatement. He was impressed by the number of areas in which Federal spending was likely to be expanding then.

In reply to questions by Mr. Daane, Mr. Gramley said that the projections assumed that the Federal budget on the NIA basis would shift into deficit in the second quarter of 1970 and that the deficit would deepen later in the year. No allowance had been made for possible reductions in Federal income taxes that might be associated with tax reform legislation since passage of such legislation was still uncertain and, in any case, the main impact of any resulting reductions in taxes would not be felt until 1971.

Mr. Brimmer noted that the projections suggested that the deficit in the Federal budget on the NIA basis in calendar 1970 would be $5 billion, roughly the same as in 1968. However, the trend during successive quarters of 1968 had been from deficit to surplus, whereas it was expected to be in the opposite direction in 1970.

Mr. Gramley agreed. He added that it was worth emphasizing that a Federal deficit was anticipated in 1970 not only because of the impact on receipts of the expected reduction, and then elimination, of the surtax, but also because of the effect of slower growth in personal income and corporate profits. The high employment budget gave a better picture of the expected impact of fiscal policy on the economy. The budgets on both bases suggested a considerable increase in the degree of fiscal stimulus in 1970, but the NIA budget exaggerated the amount of the increase.

Mr. Brimmer remarked that from the standpoint of monetary policy it was significant that the Government's financing problems would become increasingly severe as the year progressed.

Mr. Gramley concurred, noting that the projections implied that Treasury borrowing would be at about a $6.5 billion annual rate in the first half of 1970 and at about a $14.5 billion rate in the second half.

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

> At our last meeting most of the Committee agreed that there was as yet no basis for a change of policy, in view of the fact that combatting inflation remained our most important objective, and that there was as yet only fragmentary evidence of an approaching slowdown significant enough to assure real progress in attaining our anti-inflationary objective. It seems to me that nothing has happened since that meeting to justify any different conclusion.
>
> The most recent business indicators have presented a highly mixed picture. While it does appear that demand pressures have abated somewhat in recent months, they remain excessive. The economy may slow further, but any forecast of a significant slowing rests importantly on assumptions about a prospective inventory adjustment and weakness in home building that may not be borne out. Retail sales figures have been a bit stronger than they were earlier, and housing seems to have put on some renewed strength in the past two months--however temporary this strength may prove to be.

The recent jump in durables new orders plus the renewed advance in the composite leading indicators suggest how uncertain prospects for the expected slowdown may be. Even though the Federal Budget is likely to show an appreciable surplus this fiscal year, fiscal policy will probably swing rapidly during calendar 1970 toward a much less restrictive or even a stimulative posture, in the light of large prospective Federal spending increases and the prospective reduction in the surtax and its subsequent expiration.

I should note that the extension of the surcharge at 5 per cent is by no means a foregone conclusion. There is also a prospect of several expansionary fiscal measures, including a postal pay increase, a further civil service pay increase, and increases in social security benefits. While timing and the exact magnitudes are uncertain, there is considerable political pressure in each case for an effective date at the beginning of 1970. Indeed, on one pessimistic computation, the extra disposable income resulting from possible fiscal actions on taxes, pay, and benefits might be well over $10 billion, at an annual rate, in the first quarter of 1970.

Meanwhile, price inflation shows only faint signs of abatement, if any. I was especially impressed by the pervasiveness of the increases in industrial wholesale prices throughout the range of industries in September. Wage pressures remain intense, and the labor strikes expected over the coming months could add to inflationary pressures by stimulating precautionary inventory demand as well as supply bottlenecks. I would hope that a moderate rise in the over-all unemployment statistics would not bring political pressure for a premature easing of much-needed fiscal and monetary restraint.

In fact, there has been very little easing in the labor market so far. On the other hand, inflationary expectations remain strong and pervasive. Businessmen expect the slowdown to be very moderate and short, and act accordingly in maintaining, by and large, their optimistic plans for capital spending. It might be significant in this connection that corporate profits have been holding up surprisingly well.

The German mark revaluation is, of course, a distinctly useful development from the standpoint of the dollar's international position. Nevertheless, the balance of payments situation remains essentially very unfavorable, and prospects for a significant near-term improvement are lacking. One relatively bright spot may be the resumption in the coming months of heavy foreign inflows into our stock market as off-shore funds and other institutional investors reinvest their current large cash holdings in U.S. equities. But the only real hope for our balance of payments lies in the restoration of a reasonable current account surplus which cannot be achieved without an adequate cooling of the domestic economy.

Such statistics as have become available on the principal money and credit aggregates do not change materially the assessment made at the last meeting. The banking system continues to be under very substantial restraint, and the recent growth of the aggregates has been lower than would be desirable over a prolonged period. But since this comes on top of rather generous growth in the early months of 1969, I do not feel it has been a mark of excessive restraint. Based on end-of-month figures, bank credit has grown at a rate of about 3 per cent for the year to date after adjustment for loan sales to affiliates. Over the same period the money supply has also grown at a rate of about 3 per cent. While the CD outflow appears to be moderating, in good part this reflects a switching of foreign official and international deposits from the foreign branches of U.S. banks to their head offices, especially in New York.

It is in the areas of interest rates and market expectations that we have seen the principal change since our last meeting. A sharp drop in intermediate- and long-term yields has been encouraged by a steady flow of reports and comments from Washington and elsewhere of a cooling in the economy, by growing hopes of further progress toward peace in Vietnam, and by expectations of an impending change in monetary policy. The further this rate decline goes, the more risk there will be of a severe reaction should these expectations fail to be fulfilled. Thus, the partial reversal of rate movements in the past few days strikes me as a healthy development.

We are still a long way from achieving our objective of checking the inflationary spiral, and there is room for doubt as to whether a sufficient cooling of the economy is in the offing. Under these conditions I believe we should make no change in our policy of firm

> restraint, nor should we make any moves that could easily be interpreted as a change of policy in the current delicate psychological climate. Thus, for the second paragraph of the directive I would favor alternative A, which is identical with the second paragraph adopted at our last meeting. The marginal reserve targets mentioned at the last meeting should be retained--that is, borrowings in a range of $1 billion to $1.5 billion, net borrowed reserves of $900 million to $1.2 billion, and Federal funds rates generally within a span of 8-1/2 to 9-1/2 per cent. As for the Treasury 3-month bill rate, the range of 6-3/4 to 7-1/4 per cent mentioned in the blue book might be compatible with the other targets. As far as the proviso clause is concerned, I would welcome some increase in the credit proxy such as the November projections imply. In light of the delicate psychological climate, however, I would not like to see the proviso clause invoked on either side unless the deviation from the projections is quite large.

Mr. Francis noted that the money supply, bank reserves, and Federal Reserve credit had continued to show no increase for five months. In view of the usual lags between those magnitudes and total spending, the nation probably faced a sharp decline of total demand for goods and services in the near future, and, indeed, the process might already have begun. In the late summer and early fall some effects from the moderate restraint on monetary expansion in the first five months of the year appeared in the data on industrial production, employment, and housing. Much more marked effects on the economy resulting from the increased monetary restraint of the most recent five months might be expected during the next several quarters.

The Committee now had a choice of whether to continue the current degree of restraint or relax it, Mr. Francis said. No one knew exactly what the impact of the Committee's past and future actions would be on forthcoming economic activity and with what lags. However, the Board's staff had today provided the Committee with projections, and he would submit for the record a copy of projections made at the St. Louis Reserve Bank.[1/] Two alternative projections had been made by the Bank's staff: one based on the assumption that money expanded at a 3 per cent rate beginning immediately, and the other based on the assumption that money was continued unchanged until the January meeting of the Committee and then increased at a 3 per cent rate.

The studies made at his Bank indicated to Mr. Francis that, if the System did not permit some growth in key monetary aggregates beginning now, an unacceptable economic recession would most likely develop in 1970, which in turn might force the Committee into inordinate monetary expansion reminiscent of 1967. If there was no growth in the money stock until the January meeting of the Committee and then money was expanded at a 3 per cent rate, his staff calculated that real GNP would decrease at an average annual rate of about 2 per cent during the first half of 1970. But, if the System started immediately to increase the money supply at an annual rate of 3 per cent and continued that rate, there would be only a slight decline in the level of real GNP during the first

1/ The Reserve Bank projections referred to are appended to this memorandum as Attachment B.

half of 1970, and a faster recovery in the second half. On the other hand, the tighter stance now would not be of much additional benefit in reducing inflation more quickly. In either case, it appeared to him that the rate of over-all price increase would be down to about 3 per cent by the end of next year.

This morning's chart show indicated that real GNP would show little change during the first half of 1970, Mr. Francis observed. Implicit in that presentation was a quarter-by-quarter acceleration in the rate of expansion in money until a 4 per cent rate was achieved in the last half of next year. His Bank's studies indicated that the implied growth in money was too slow for the next three quarters if the Committee desired to avoid an excessive slowing in real GNP expansion.

If the System did not moderate its course soon, Mr. Francis continued, the likelihood was great that it would be following a course of gyrating policies from one extreme to another--a type of course which had been followed in the past and for which the System had criticized itself and had been criticized. Whether or not the recent and current extremely restrictive policy was continued, declines in interest rates might be expected as demands for credit and inflationary expectations receded, a development which might already have been started in October. Following what he believed was the most appropriate policy, interest rate declines would result both from the renewed moderate monetary expansion and from declining loan demand accompanying slower growth in total spending. The decline of interest rates would be comparable in nature to that of late 1966 and early 1967.

Some suggested that the System dared not take any step which would be interpreted as easing because that would reinforce public expectations of excessive demand and inflation, Mr. Francis remarked. In his opinion, the conduct of monetary policy by attempting to control public psychology directly rather than through control of financial magnitudes had not been and would not be successful.

In Mr. Francis' opinion, the Committee should take a mix of three steps immediately if the economy was to avoid further severe dislocations from monetary actions: resume moderate monetary growth; raise the discount rate in line with market interest rates; and lift Regulation Q ceiling rates, especially for large CD's. If it was believed that any adverse psychological or expectational effects would develop from any of those actions, they could be offsetting if the System announced simultaneously--as he believed it should in any event--that:

1. It intended to manage its holdings of Government securities in the near future with a view to achieving a moderate rate of growth in M_1, in contrast with the zero rate of the past five months and with the 7 per cent rate of 1967-68.

2. The discount rate was being raised to a point in touch with short-term money market rates. The System should announce that that action was not a further tightening measure and was neither intended nor expected to raise market interest rates, but was a technical step to correct an intolerable condition at the discount window. It should also announce that it was its intention to lower the discount rate when and as short-term market rates declined.

3. Regulation Q limits were being raised, especially on large CD's. It should be announced that that action was intended neither as a tightening nor as an easing measure, and that it was not expected as such to raise or lower general market interest rates; but that the purpose was simply to arrest the extreme disintermediation which had affected the financial system since the first of the year. It might say that that, of course, in no way precluded reduction of interest rates paid by banks when and as supply and demand conditions brought down general market rates.

In conclusion, Mr. Francis said he would urge that the Committee not continue through the remainder of this year its recent practice of no increase whatsoever in the strategic monetary magnitudes.

Mr. Kimbrel reported that in the Sixth District, as in the nation, evidence was appearing which could be interpreted as indicating the beginnings of a slowdown. In September nonfarm employment, for example, showed only a diminutive increase, and the unemployment rate increased fractionally. The dollar value of plans announced for new and expanded manufacturing plants in the third quarter for the Sixth District was down substantially from the second quarter, thus continuing the declining trend. Loans at member banks as a group were being held up only by a decline in investments as the banks continued to lose time deposits. Bankers at the District's larger banks were complaining bitterly about the impact of Regulation Q. A good case could be made that by continuing a policy of restraint the System was risking a greater reaction than it intended.

Nevertheless, Mr. Kimbrel thought it had to be admitted that there also were substantial risks involved in moving toward less restraint. First of all, there was the risk that the "standard" forecast that was gradually being accepted could be wrong; such forecasts had been wrong before. It was persuasive but not conclusive. Moreover, apparently a great many bankers, businessmen, and members of the public would welcome a chance, at the first sign of relaxation, to prove by their actions that those who had forecast a slackening of inflationary pressures were wrong.

Mr. Kimbrel said that bankers told him that they did not see any lessening in the demand for loans. If fewer applicants were showing up, it was only because would-be borrowers knew that the banks would turn them down because of a shortage of loanable funds. Bankers told him that they believed the first sign of relaxation would be immediately followed by an intensification of loan demands. When it came to their own operations, some of them favored relaxation in the hope that it would reduce pressures on them, not because the demand for credit had fallen off. Many businessmen he talked with seemed to be merely waiting for the signal of relaxation before resuming capital spending that had been temporarily shelved. The prevailing mood was an expectation of continued inflation, and plans were being made accordingly. Under those circumstances, it seemed to him that the greater risk was that a move toward relaxation would be interpreted as validating expectations for continued inflation.

That risk, it seemed to Mr. Kimbrel, was recognized in the discussion in the blue book of possible developments that might follow the adoption of a policy toward somewhat less firm conditions in the money market set forth as alternative B. It was pointed out that even a slight easing could raise expectations of further easing. For those reasons he would, if he had a choice, favor the adoption of a directive patterned after alternative A.

At the same time, Mr. Kimbrel continued, he was disturbed over the inordinately tight squeeze into which Regulation Q, along with the System's present policy of maintaining firm conditions, had put the banks. He acknowledged that the banks were the instrument through which the System had to operate, and, therefore, that the banks had to feel the impact of any policy of restraint. Yet, the continued decline in time deposits at banks through CD attrition was adding an element of increasing restraint on the banks when the System's intention was not to increase restraint but only to maintain it.

Mr. Bopp said that for some months now, in preparing for meetings of the Committee, he had tried to evaluate the role of purely economic forces and the role of expectations. For a considerable period both had been clearly inflationary and had called for monetary restriction. More recently, economic forces had moderated, and they promised to moderate further in months immediately ahead. However, expectations of inflation had continued strong. Because of that expectational element, he had been loath to see any relaxation of restraint.

However, Mr. Bopp continued, a difficult question now was how to interpret the more buoyant atmosphere in financial markets. It could reflect a belief that public policy was succeeding in curbing inflation and that demands in credit markets were slackening. It could also mean that the market believed the Federal Reserve was so concerned about rising unemployment that a move to ease was imminent. The first explanation assumed that expectations of inflation had died down; the second, that they were still strong.

Mr. Bopp hoped the first explanation--that declining rates signaled reduced demand for funds and a conviction that the inflation fight had been won--was true. He saw little evidence of weakening on the demand side, however. For example, the impression he got from banks in Philadelphia was that the demand was still there. Moreover, if inflationary expectations were weakening--and he was not at all sure that was the case--he believed they could be revived easily and with the slightest excuse.

Eventually, of course, the Committee had to ease, Mr. Bopp observed. Moreover, there was a danger that if it kept its eyes focused on the target of interest rates as the real economy slowed down, it might find the volume of money and credit progressively declining. It was even possible that that had already been happening and explained the continuous decline in total reserves and deposits in the past few months under a "no change" policy. If the Committee was to accomplish only modest growth in money and credit, interest rates probably would have to decline. The problem, of course, was that to the extent that the market was conditioned to following interest rates as a guide to System policy, it could take such a decline as evidence that inflation was likely to accelerate after, at best, only a brief slowing down.

In the longer run, Mr. Bopp continued, expectations had less impact than underlying conditions of the supply of money and credit. One could argue, therefore, that even if the market interpreted a decline in rates as fuel for inflationary expectations, those expectations could not survive continued restraint on the money and credit aggregates. Nevertheless, in the current atmosphere, short-run considerations were particularly important, and expectations could greatly complicate and prolong the Committee's task of slowing inflation.

Accordingly, Mr. Bopp believed the Committee should be careful not to appear to be trying to push down interest rates. Should demand for funds decline, however, and rates begin to fall, he would not try to roll them back. He would vote for alternative A for the directive. He was glad that implicit in that alternative of no change was some growth in bank credit and bank reserves. Some growth in those variables now seemed acceptable in light of the substantial declines during the past several months.

Mr. MacDonald said it appeared to be the general opinion in the Fourth District that the pace of real economic activity would continue to decline in the final quarter of 1969 and through the first half of 1970, in spite of the temporary interruption in the third quarter; and that the slowdown would be accompanied by an increase in unemployment and by some easing in inflationary pressures. That view was supported by the "consensus" forecast of business economists who had attended a regular outlook session at the Cleveland Reserve Bank on October 17.

The median forecast of that group of about 40 economists representing major corporations, Mr. MacDonald continued, indicated a $12 billion gain in GNP in the fourth quarter of 1969, and further slowing in current dollar gains to about $10 billion in both the first and second quarters of 1970. The economists were nearly unanimous in the view that recent fiscal and monetary restraint, accompanied by inventory adjustment, would be the major factors underlying the anticipated slowdown through the first half. Continued curtailment in residential construction and sluggishness in capital spending were expected during the first half of next year, and industrial production was expected to recede further. The group's forecast implied a reduction in the rate of price increase--as measured by the GNP deflator--during that period.

Mr. MacDonald said that an acceleration in economic activity during the second half of 1970 was also indicated in the median forecast, with current dollar gains amounting to $16 billion and $19 billion during the third and fourth quarters, respectively. The stepped-up pace would be supported by moderate growth in Government expenditures, followed by more rapid inventory accumulation and a resumption of upward price pressures. More importantly, a key assumption in the group's forecast was that there would be an abrupt shift in monetary policy from the highly restrictive posture of recent months to considerable ease. Such a policy shift would encourage a sharp recovery in construction, particularly residential. Many participants were quite emphatic that, in the face of slowing business activity, the monetary authorities would likely err by increasing credit at an excessive rate before inflation and inflationary expectations had been brought under control.

In Mr. MacDonald's judgment, the views expressed at the business economists' meeting provided additional support for the adoption now of a monetary policy of more moderate restraint that could be maintained for an extended period. Such a policy would help to avert a sharp upswing in GNP during the second half of 1970 that would nullify the System's recent efforts to control inflation. It would seem prudent, therefore, to support the recent easing in financial market conditions by moving to achieve sustainable positive growth rates in the monetary and bank credit aggregates.

Mr. Sherrill said developments in the past three weeks offered ample evidence of the degree of interaction between the real world and the world of expectations. He thought the explanation of those developments was that expectations had kept the real world from reflecting as much restraint as it would have otherwise. The strength of expectations in itself involved something of a paradox; because the economy appeared to be cooling it was expected that monetary restraint would be relaxed and that that, in turn, would lead to a new economic upsurge.

Mr. Sherrill expressed the view that the posture of restraint in fiscal policy was in real danger of giving way to stimulus. It was quite possible that the income tax surcharge would be permitted to lapse on January 1 because of expectations that the economy would cool more than he personally thought likely. Moreover, any tax reform measures probably would be accompanied by tax reductions. If both monetary and fiscal restraints were being relaxed simultaneously, a resurgence in the expansion of the real economy was quite likely. Accordingly, he would not want to relax monetary policy at this time. That view was reinforced by the fact that the projections for slowing in the economy were based in good part on expectations of continued moderation in consumer spending. He was not sure one could count on that moderation, particularly since the rate of increase in disposable income was up sharply in the third quarter.

He recognized the risks in continuing the present posture of monetary restraint, Mr. Sherrill continued, but he thought there would be greater risks in a relaxation. Monetary restrictions were fatiguing when they had been in effect for so long a period, particularly when they had shown so little result. But if the grip of monetary policy were loosened it probably would prove impossible to take a second grip should there be an economic resurgence. Under those circumstances there would be a real possibility that direct controls would be imposed. Despite the fact that he found recent developments with respect to the monetary aggregates to be disquieting he favored alternative A for the directive.

Mr. Brimmer said he was grateful to the staff for their detailed projections, which he had found quite helpful. He recognized the difficulty of making projections for so long a time period, and he noted that those presented today were based on certain specific assumptions about policy. He hoped anyone who might look back at some future time to assess the accuracy of today's projections would take both of those considerations into account.

Mr. Brimmer then remarked that the outlook portrayed by the staff for production, employment, and unemployment in the first half of 1970--particularly the declines in real GNP foreseen for two successive quarters--were of a type that would lead most analysts to classify the period as one of recession. The levels to which unemployment was projected to rise next year were consistent with recessionary tendencies in the economy. At the same time, prices were expected to be still rising at nearly a 3 per cent annual rate in the last quarter of 1970. That posed the classic dilemma of trade-offs and priorities among conflicting goals of policy.

Mr. Brimmer said he thought the Committee should face up squarely to the fact that a recession early next year might well be inherent in the course it was following, and that it should face directly the question of priorities among its various objectives. He personally thought it would be desirable to keep policy on its present track for at least a while longer, and accordingly he favored alternative A for the directive. In his judgment it was not as difficult to reach such a conclusion today as it was likely to be at coming meetings. He suspected, however, that it would prove necessary to hold to the present policy course for some time.

Mr. Maisel said he would like to speak again to the proposition that allowing more freedom in money market conditions now would result in a better money and credit situation and one that would involve fewer shocks to the economic system. It would mean less "stop and go" in monetary policy and a better adjustment of policy to economic flows. The question, in his view, was how to allow economic conditions to influence credit in the proper direction and manner. How could the Federal Reserve follow the logic of its own operations? It should be able to use current information and not be constrained by the straitjacket of economic projections, which was a matter separate from that of the nature of the projections themselves. He thought such a position was implicit in Mr. Partee's observation during the chart show to the effect that, while consistency with the staff's projection would not require overt policy action at present, it did presuppose a readiness to accommodate interest rate declines initiated by the market.

As he saw it, Mr. Maisel continued, the development of a logical policy now was related to decisions with respect to the form of the Committee's instructions to the Manager in the directive, as supported by the specifications given in the blue book. There were three major problems. First was a problem of semantics: how should the Committee formulate an instruction to the Manager not to tighten further, assuming that was its wish? Related to that was the problem the Manager faced in his operations of following any tendencies in the market toward greater ease--if that was the direction of the underlying pressures in the economy--rather than forcing greater tightness. The second problem was that of insuring that there was no major change in expectations in the market as a result of day-to-day events and the Desk's operations. The third problem was suggested by the Manager's comments, in his statement today, regarding his recent actions under the proviso clause; it arose from the fact that the projections referred to in that clause ordinarily related to bank credit developments in a single month, whereas the Committee's main concern clearly was with trends over a longer period. Adopting alternative B for the directive would not appear to be at all helpful in dealing with those various problems.

With respect to the first problem, Mr. Maisel observed, the situation appeared to be asymmetrical. Earlier this year the Committee had instructed the Manager at successive meetings to maintain current conditions, but the Manager had in effect not opposed the market's tendency to tighten further and the Committee had accepted the results at each subsequent meeting. But the Committee did not seem to be able to follow the same course when the market's tendency was in the opposite direction. The Manager felt constrained to attempt to hold the daily Federal funds rate as close to 9-3/4 per cent as possible, providing the estimate of net borrowed reserves did not exceed $1.2 billion--which was consistent with the Committee's instructions. It meant, however, that the Manager could allow market forces to influence actual conditions only when banks made miscalculations in managing their reserve positions and there were sharp decreases in the Federal funds rate on the last day or two of the weekly period.

As a result of the situation he had described, Mr. Maisel said, unless the Committee gave the Manager specific instructions on the matter it would not be able to get results of the type that previous speakers today had indicated they favored; it would never be able to permit market conditions to do their part in determining rates and flows. One example of a situation in which there would be a need for greater flexibility might be that in which there was a divergence between movements in Euro-dollar rates, commercial paper rates, and the Federal funds rate, of which the last was the one most easily dominated by the Desk.

As to the second problem, Mr. Maisel observed, it was clear that the Committee thought that a change in the wording of the directive and in the Desk's day-to-day operations might result in a major change in market expectations. There was nothing in the current directive that guarded against that.

Finally, Mr. Maisel said, the third problem was a consequence of the fact that the rate of change in the bank credit proxy fluctuated widely from month to month, largely because of the effects of Treasury financing operations. Thus, for November a fairly sizable increase in the proxy was projected, even though November was the middle month of a quarter in which no increase at all was expected on average. The size of the projected November increase might be worrisome only if it was considered alone, without reference to the change in the longer period of which November was a part.

Mr. Maisel thought all three problems required some change in the directive and operations. He believed the manner in which specifications were formulated in the blue book should be modified to give the Manager more leeway to allow the tendency of market forces to be reflected in rates. The Manager should be told to consider 9-1/2 per cent as a ceiling for the Federal funds rate in reaching decisions on his daily operations, on the assumption that the average for the week would fall below 9 per cent if that was the tendency of market forces. It would be best to use a one-way proviso with respect to bank credit and add a proviso on interest rates, along the following lines: "provided, however, that operations shall be modified if bank credit appears to be expanding significantly less than currently projected or if market interest rates are tending to decline unduly." Second best would be retention of the two-way bank credit proviso shown in the staff draft, with the addition of an interest rate proviso reading as follows: "...or if modifications are necessary to resist unduly large declines in market interest rates."

Mr. Daane said he did not concur in Mr. Francis' suggestion that the discount rate be increased, whatever pains might be taken to describe the action as technical. Nor did he favor the other actions Mr. Francis had proposed.

More generally, Mr. Daane continued, he thought that there was no basis for relaxation of monetary policy at this juncture, and that there were grounds for considerable apprehension that the stimulus from fiscal policy might come sooner and in larger measure than the staff had projected. He was uneasy about the similarity between the current situation and that of the fall of 1965, when Federal defense spending was entering a period of sharp expansion. He did not expect defense spending to rise sharply now, but he was disturbed about the outlook for other types of Federal outlays. He also shared Mr. Sherrill's concern about the tax outlook. Chairman McCracken of the Council of Economic Advisers recently had publicly said that failure to extend the surtax at 5 per cent through the first half of 1970 would add about $5 billion at an annual rate to the Federal deficit in that period, and that failure to repeal the investment tax credit would add another $1.5 billion to the deficit. If one added a few billion dollars to budgeted expenditures to allow for probable overages--some of which were already matters of public knowledge--one could easily arrive at an estimate that the deficit on an NIA basis would be at a $10 billion annual rate in the first half. He did not hold any particular brief for that figure, but he did feel that fiscal policy was on the verge of a large shift toward stimulus.

It was against that background, Mr. Daane observed, that he had concluded that there was no justification for a relaxation of monetary policy now. While there were some questions in his mind about the appropriate course of policy in the future, he favored alternative A for the directive today.

Mr. Mitchell said he favored alternative A for the directive, on the grounds Mr. Bopp had advanced.

Mr. Mitchell added that he agreed with Mr. Maisel that the Committee was having a difficult time in connection with its instructions to the Manager; as Mr. Maisel had indicated, monetary policy had tightened during a period when the Committee had been issuing "no change" directives. In that connection he noted that Mr. Maisel was chairman of a committee, also including Messrs. Morris and Swan, that had undertaken to review the format of the directive. He asked whether that group might be expected to offer constructive suggestions soon.

Mr. Maisel replied that the directive committee had held two meetings and that its work was progressing. However, he did not expect that it would be able to make its report in time to help the Open Market Committee deal with the directive problem it now was facing.

Mr. Heflin said he was inclined to agree with Mr. Brimmer's comment that it was easier to reach a decision for no change in policy today than it was likely to be at coming meetings; at the moment he thought there was no real alternative to holding to the present stance of policy. He had reached that conclusion despite the fact that recent data for the Fifth District--which in some respects were more current than the national figures--offered clearer indications of a slowing of the pace of activity than had been evident earlier. The indications were particularly sharp in the textile industry, but there had also been a marked slowing in general retail trade and automobile sales, and construction activity had continued in a steep decline. Sentiment in both the banking and business communities appeared to have taken a bearish turn lately, and nearly half the businessmen in the Reserve Bank's latest survey now expected some decline in activity in the months ahead.

In contrast, Mr. Heflin continued, recent national statistics--particularly the third-quarter GNP figures and the September data for new durables orders and for housing starts--suggested that progress was being made at only a moderate rate. The continued rapid increase in consumer and industrial prices in September was discouraging, although not altogether unexpected. But as far as today's policy decision was concerned, he believed the current rate of inflation was less important than the question of what was happening to the underlying upward pressures on the price level. He thought there were some encouraging signs that the peak pressures might be past, and there also were signs of a turnaround in the patterns of expectations in both the business community and the bond markets. But while there may have been considerable progress in those areas, he agreed with Mr. Sherrill that it was too early to consider actions that might turn loose the tremendous pent-up demands of consumers. On that ground, and in light of the outlook for Government expenditures, he thought it would be a mistake to relax monetary policy at this time.

Mr. Heflin said he was convinced that the task of returning the economy to a sustainable growth path would require two--and perhaps three--quarters of growth in spending at a rate well below that indicated for the third quarter. Despite the staff's excellent chart presentation this morning, he had serious doubts that that much moderation was a firm prospect. Accordingly, he was prepared to hold to the current degree of restraint a while longer, and he favored alternative A for the directive today.

Mr. Clay observed that there were some indications of progress in the effort to slow the excessive pace of economic expansion. However, those developments had only laid the groundwork for the more difficult part of the struggle to restrain price inflation and restore price stability. He said that with full recognition of the lagged impact on prices in the correction sequence.

It was going to be very hard to bring price inflation under control, Mr. Clay continued. Not only was the inflation disturbingly strong, but inflationary expectations did not seem to have lessened significantly. There did appear to be a heightened public recognition of the inflation problem and the need to correct it, but there was a lack of confidence that it would be dealt with successfully.

Mr. Clay said the potential for, and indeed a substantial risk of, continuing inflationary pressure was going to come from wage negotiations between labor unions and business management. The outcome of those bargaining sessions would be crucial. Public economic policy success in moderating the pace of economic activity, with its impact on corporate profits and the demand for labor, could be a substantial restraining force in those negotiations.

Because the economic stabilization effort was approaching a crucial stage, Mr. Clay believed it was important that moderation of economic activity continue and that inflationary expectations be dispelled. A complicating factor in the attainment of that goal was the fairly common projection of economic events that included a marked upturn in activity by mid-1970. Unfortunately, considerable uncertainty had arisen as to the degree of restraint that could be expected from fiscal policy in the months ahead. That made the role of monetary policy all the more important. Accordingly, monetary policy should be continued without relaxation.

Mr. Clay said that alternative A of the draft economic policy directive appeared to him to be satisfactory.

Mr. Scanlon noted that tentative drafts of the second paragraph of the current economic policy directive had been included in the blue book prepared for this meeting. He had found that procedure helpful and hoped it would be continued.

Mr. Scanlon then said he would summarize the statement he had prepared on economic conditions in the Seventh District and submit the full text for inclusion in the record. He summarized the following statement:

> There is widespread acceptance among business economists in the Seventh District of the view that monetary and fiscal measures are gradually taking hold and that real growth will be slight (or cease temporarily) in the first half of 1970.
>
> We have no local evidence to support the apparent resurgence (shown by national data) in housing starts and in orders for durable goods in September. Neither do we have local evidence that unemployment increased significantly in September as indicated by national data. On the other hand, we have ample confirmation that prices of goods and services have continued to rise at a rapid pace.
>
> Labor shortages persist in most industrial centers. This is true for unskilled and semi-skilled as well as for skilled workers. Steel output continues to be limited by labor availability. The supply of trainable job applicants for both factory and white collar jobs is reported by personnel managers to be even less adequate than last year. The job situation appears to be easier in the smaller towns, but workers in such areas are seldom prepared to move to large centers where jobs are more plentiful. Despite the decline in home building, shortages of trained construction workers (especially those who work with machinery and metals) are severe, particularly in the Chicago and Indianapolis

areas. Wage increases for construction workers are averaging 15 per cent annually. For other contracts we are told increases of 10 per cent may become the norm in months to come.

Price increases have been frequent and substantial for such products as appliances, machinery, vehicles, metal products, instruments, and electrical goods. Charges for services have increased very sharply. In September, 82 per cent of Chicago purchasing agents reported paying higher prices, compared with 60 per cent a year earlier. Supply and demand prospects for agricultural products indicate that recent price declines for these commodities have run their course.

Steel demand continues vigorous, but order lead times are very short. Order books are not firming up for coming months as rapidly as had been anticipated.

While declines in auto sales in the first 20 days of October are partly a result of strikes at General Motors, reports from Detroit indicate distinct uneasiness concerning sales trends. Production schedules for the fourth quarter, and for early 1970, may be adjusted downward.

The surge in construction contracts nationally in August (attributed to certain large projects) was not duplicated in the Seventh District. For this region, contracts reported by F. W. Dodge were down 9 per cent from a year earlier in August--and were the lowest since August 1967. The commercial, manufacturing, and residential sectors all participated in the drop from last year in August. For the first seven months of 1969 construction contracts in this area were up 9 per cent.

Mr. Scanlon went on to say that while there were some indications that over-all credit demand might be softening somewhat, bankers continued to forecast a substantial overhang of demands for credit. The big banks continued to operate with almost no cushion of liquidity, except for their ability to tap the commercial paper or Euro-dollar markets. Their holdings of securities had continued to decline, except for the temporary impact of Treasury financings, with holdings of municipals off quite sharply. Loan rationing appeared to be continuing and one of the Seventh District's largest banks had announced that a premium above the prime rate was being charged customers on accommodations in excess of their normal borrowings. The impact of the high cost of loanable funds on third-quarter bank profits might have a further restrictive effect on loan policies.

As to policy, Mr. Scanlon said his position was identical with that expressed by Mr. Bopp. He did not favor an overt move toward ease at this time. He would accommodate any easing in the market that was attributable to a lessening of credit demands. He recognized that the Committee could not accomplish that if it used an interest rate objective as its criterion. He confessed that the Committee's current measures for determining changes in credit demands left much to be desired.

Mr. Scanlon favored alternative A of the draft directives.

Mr. Strothman remarked that the projections presented for this meeting in a way were reassuring--and supportive of continuation of the Committee's policy of the recent past. That seemed to be consistent with an unemployment rate averaging 4.5 per cent in the second quarter of next year. And all things considered, a 4.5 per cent unemployment rate was tolerable, at least over some interim period.

Mr. Strothman noted that the Board's staff projected that the unemployment rate would increase further in the second half of 1970--to 5.0 per cent in the fourth quarter. That might well be too high a rate, even for a transition period. But if the Committee waited until early next year to change policy it could still influence the unemployment rate in the second half of 1970. And by early 1970 the Committee should have a better fix on the second half of that year than was presently possible. In particular, it should have a better fix on business fixed-investment spending for the second half. Mr. Partee and his associates were projecting a 4.0 per cent increase, year-over-year, in capital spending. He thought that reasonable, but as the Committee was aware, there were some survey results which suggested larger increases.

There might be some risk in delaying a policy change, Mr. Strothman said. Delay could make extension of the surcharge that much more difficult; it might be argued that with monetary policy remaining extremely restrictive, there was no need to extend the surcharge. But it might also be argued from an observed easing of policy that the Federal Reserve had denied the need for extending the surcharge. Congress might not grasp that a change in the mix of monetary and fiscal policies was necessary.

Not knowing the effect on Congress of any Committee decision, Mr. Strothman continued, the members could only act as if there were none. Therefore, he was for no change in Committee policy this morning. To repeat, delaying a policy change was consistent with a reasonable unemployment rate for mid-1970; and should it want to, the Committee would still be able to do something about developments in the second half of 1970.

Mr. Strothman favored alternative A of the staff directives and the monetary targets associated with that alternative in the blue book.[1/]

Mr. Swan remarked that he would not comment on Twelfth District conditions this morning except to note one development. According to the San Francisco Reserve Bank's very limited sample of five savings and loan associations, there had been a substantial savings outflow in the first three weeks of October. Of the five associations, four had reported rather significant losses, and the very small gain reported by the fifth was centered in a new branch it had just opened. Thus, it appeared that the situation at savings

1/ The blue book passage referred to read in part as follows: "Prevailing firm conditions in the money and short-term credit markets might be taken to encompass ranges for the Federal funds rate of about 8-1/2 - 9-1/2 per cent, for member bank borrowings of $1 - 1-1/2 billion, and for net borrowed reserves of $900 million to $1.2 billion--in each case, the approximate ranges prevailing since the last meeting of the Committee . . . the 3-month bill rate seems likely to fluctuate in a 6-3/4 - 7-1/4 per cent range . . . total member bank deposits . . . are expected to grow on average at an annual rate in a 5 - 8 per cent range in November, supported by a 4 - 7 per cent annual rate of growth in nonborrowed and total reserves . . . the bank credit proxy adjusted to include Euro-dollars and other nondeposit sources is projected to rise on average in November in a 6 - 10 per cent annual rate range."

and loan associations was a rather weak one. In conjunction with the lack of strength at banks in consumer-type time deposits and CD's, that suggested that some consideration should be given to raising some of the ceiling rates under Regulation Q--not only on large-denomination CD's but perhaps also on longer-term CD's of any denomination--and taking equivalent action for savings and loan associations.

Turning to monetary policy, Mr. Swan said that in view of the so-called "cross-currents" in recent monthly economic statistics, in view of the interest rate developments since the Committee's last meeting, and in view of the November projections for the monetary aggregates, he would accept alternative A for the directive today. But like Mr. Scanlon he would hope that any tendencies toward easier conditions that might be generated by the market itself would not be fully offset by System operations. It was true that some such tendencies might reflect purely expectational factors, and some might represent over-reactions to Vietnam peace rumors and the like. Nevertheless, if the market continued to transmit messages of easing tendencies, those messages deserved to be heard. As to the monetary aggregates, he did not know whether or not there were any questions about the adequacy of the seasonal adjustment factors, but he was impressed by the fact that the latest estimate of the decline in bank credit in October and the increase projected for November would nearly cancel each other out.

Mr. Swan said he had a few comments on the language the staff had proposed for the first paragraph of the directive. One sentence in the draft read "Most market interest rates have declined considerably on balance from their recent highs, in large part because of changing expectations." For the sake of clarity it might be helpful to add a phrase indicating the kinds of the expectations that had changed. Secondly, the language of the statement reading "In the third quarter, average monthly bank credit declined . . ." struck him as extremely awkward. He supposed that the reference intended was to the change in the bank credit proxy from the end of the second quarter to the end of the third, but he was not sure. Finally, the statement that "In recent weeks . . . flows of consumer-type time and savings funds at banks and non-bank thrift institutions appear to have remained relatively weak" seemed to him to imply that there had been inflows but not of substantial size. He doubted very much that there had been inflows in recent weeks. Perhaps the staff had good reasons for the constructions it had proposed at each of the points he had mentioned, but he thought it might be possible to improve the language at those points.

Mr. Partee commented that the staff had suggested a reference to weak "flows" in the third statement Mr. Swan had cited because it was not known at this time whether there actually had been net inflows or outflows in recent weeks on a seasonally adjusted basis. There might well have been net outflows, but data were not yet available to document a statement to that effect.

Chairman Martin commented that he did not consider the problems mentioned in the draft language to be particularly serious.

Mr. Coldwell observed that the Eleventh District economy appeared to be cresting, with gains now minimal and a few losses surfacing. Industrial production in Texas fluctuated with the dominant oil and gas industry but, excluding the effects from mining, there was a distinct slowing of the upward pace. Employment was rising more slowly and unemployment was creeping upward. Similarly, retail sales had stopped advancing in a physical sense and construction activity--although up recently--was on a downward trend. Agricultural output in cotton was estimated to be 8 per cent below the 1968 crop, while smaller crops and citrus were showing good gains and the livestock industry was advancing sharply.

Mr. Coldwell said the District banking picture showed loans and demand deposits declining while investments and time and savings deposits increased. However, the latter appeared to be just minor interruptions in the downward trend of 1969. The tone and feel of District banks reflected some relief from the intense restraint of the summer months. Borrowings from the Federal Reserve Bank were sharply lower and talk was heard of a number of country banks now seeking participations or continuously selling sizable blocks of Federal funds. The larger banks insisted that demand was just as strong as ever and that it was restrained only by lack of available funds.

Mr. Coldwell remarked that he would not take the Committee's time to review the national economic conditions already reported. However, he would point out that there were interpretations of future conditions differing from those presented by the staff in its most interesting chart show. The Committee was dealing in futures, and it was in that area that he saw some crucial differences.

One interpretation of the coming six months, Mr. Coldwell continued, reflected a form of surface stability in the growth rate of GNP in current dollars but a wide range of internal shifts. In effect, that outlook assumed sufficient price inflation and impact from past increases in prices to keep the GNP changes in the narrow $16 billion to $18 billion band of the past five quarters. There were some who looked for further growth in the coming months based on a resurgence of consumer spending and a relaxation of fiscal restraint.

Personally, Mr. Coldwell said, he was skeptical of the deep declines in growth of dollar GNP in the first two quarters of 1970 that were forecast by the staff. But he was equally skeptical of a near-term resurgence of consumer spending. In his opinion there was a real possibility of a high degree of stability in the growth of over-all GNP, perhaps slanted downward by $1 billion to $2 billion per quarter.

Mr. Coldwell commented that the financial trends of the past few weeks as well as the operations of the Desk appeared to have already signaled a policy change to some in the market. If that view were to become widespread he believed it would be unfortunate, not only because of the false hopes it raised for future credit availability and yields, but also because he saw only a slight diminution in the inflationary expectations of business. If the resurgence were abetted by policy, the Committee would be encouraging the very credibility gap it sought to close.

As he saw the Committee's problem over the next few months, Mr. Coldwell continued, it would be to begin a slow move toward permitting some reserve aggregate growth in a manner that kept the move a secret from the market. More specifically, he believed the Committee should begin to think about permitting bank funds to be enlarged but keep the news of that growth from regenerating speculative and inflationary expectations. To achieve such a move and keep it from being the cause of major problems, he thought the Committee should consider such possibilities as implementation of a simultaneous increase in the Regulation Q ceilings for CD's of $100,000 and larger and imposition of a strong limitation on the issue by commercial bank affiliates of commercial paper and bank letter-of-credit guarantees. Such simultaneous moves, which should be well publicized, could rechannel the available funds into bank time deposits while sharply reducing off-balance-sheet financing in the commercial paper market.

For the present period, however, Mr. Coldwell thought the System should keep its restraint intact. Any encouragement to the financial markets or to business could lead to the development of expectations which, if unfulfilled, could mean a sharp reversal and perhaps even a disorderly decline in securities prices. Thus, he favored alternative A for the directive. He would prefer to avoid specification of market conditions, but would say instead that he favored maintaining the feeling of tautness that had been evident in late September.

Mr. Morris said he wanted to commend the staff on the excellent longer-term analysis they had presented today. It seemed to him that the Committee needed to formulate a longer-term policy stance at this juncture, rather than merely contenting itself with the much easier task of defining policy for the next four weeks.

The evidence suggested to Mr. Morris that it was necessary to formulate a policy which could exert financial restraint for a considerable period of time to come. He had no doubt that the economy was cooling, but the strength of the indicators of new investment commitments in September suggested that the cooling process was proceeding considerably more slowly than had been hoped. He was also concerned about the fact that the Federal Budget was moving from restraint to stimulus, and that the stimulus could become very substantial if the surcharge was eliminated entirely on January 1. And, with the personal saving rate now back to relatively high levels, he was concerned about the possibility of another unpleasant surprise from the consumer like that in the second half of 1968.

It was for those reasons that Mr. Morris believed the Committee should formulate a long-term restrictive strategy. His concern with respect to the policy the Committee had been following since May rested on a conviction that it was not a viable long-term policy. He would like to see the Committee edge away from that course before events forced it off it. He would support alternative B as a means of getting onto a sustainable restrictive policy course.

He recognized that even the subtle change implied in alternative B might generate expectations of a major change in policy, Mr. Morris continued. He thought, however, that any such expectational effect would be short-lived, as the market assessed the action and recognized its limited extent. The great advantage of monetary policy as a stabilization instrument was said to rest on the fact that it could be used very flexibly. But the Committee's concern about market expectations--which he thought was excessive--tended to inhibit the use of that flexibility and to limit policy changes to major changes.

Mr. Morris recalled that J. P. Morgan had once explained his success in the stock market by saying it was his practice to "buy too early and sell too soon." He thought there was a moral in the story for the Committee. If the objective today was to set a policy for only the next four weeks, the choice between alternatives A and B for the directive probably would not make much difference. On the other hand, if the Committee was concerned with trying to formulate a longer-term policy that would be consistent with the economic projections, this was a juncture at which it should consider some modification in its stance--simply because the growing lack of liquidity in the economy was going to force the Committee off its present policy course soon, if not necessarily in the next four weeks. The question was whether the Committee should be forced to move by events or should initiate the action itself. He had enough confidence in the ability of the market to adjust to a more flexible use of monetary policy to support alternative B for the directive.

Mr. Robertson made the following statement:

> The data that have become available to us since the last meeting tend to establish the correctness of our decision then to continue a restrictive monetary stance. They also suggest that we should hold to our present course for at least another four weeks. While it is likely that the economy will slow down in the current quarter, and possibly slow even further in the first half of next year, it is also possible that the second half of next year may be strong and that, even given a slowdown in coming months, inflationary pressures may not be satisfactorily contained.
>
> I realize that the second-half strengthening next year is predicated on an eventual easing of monetary policy from its current course--as has been assumed in

the excellent chart show we saw this morning--but for us firmly to judge the extent and timing of ease that is desirable requires more certain knowledge as to how fiscal policy will develop and more time to sort out the implications of the puzzling recent economic information. The spurt in new orders for durables, the rise in housing starts, and the somewhat unexpected strength of pressures on consumer prices as indicated by the latest index are disquieting insofar as they cast doubt on the extent to which inflationary pressures are under control. On the other hand, recent declines in industrial production and evidence of excess inventories in certain areas, particularly comparing inventories of durable goods manufacturers with unfilled orders, are consistent with an economic slowing in process.

The restraint on the monetary aggregates also seems to me consistent with an economic slowing. Thus, I would not like to see any sharp, sustained rebound in growth of bank credit or of the money supply. While the November proxy is projected to show considerable growth, October did show a sharp decline and the proxy for the fourth quarter as a whole looks as if it will be about flat. At the same time, I would not be disturbed if the money supply were to grow at around a 2-3 per cent annual rate over the fourth quarter, which appears to be slightly faster than indicated by the projections given us for October and November taken together. More money supply growth than the less than 1 per cent annual rate we seem to have experienced in the third quarter would not seem inappropriate, given the economic outlook, but a growth on the low side of historical standards still seems desirable in view of the lingering inflationary expectations.

As to interest rates, I do not think we should resist rate declines, unless they were to be accompanied by a sustained surge in bank credit growth or a rapid expansion of the money supply. And if declines in the bill rate or longer-term interest rates were to begin dragging down the Federal funds rate, I would not work too hard attempting to hold the funds rate up, especially if that resulted in undesirable weakness in the monetary aggregates. Finally, if interest rates rise following their recent dip, as some now seem to expect, I would let the process develop to some extent. But I would not let it snowball, and I would not be reluctant to throw

> in some reserves to moderate it--recognizing that the projections of monetary aggregates we have been given are on the tight side, after allowing for monthly fluctuations, and would seem to provide some leeway for reserve provision in these circumstances.
>
> With this background, I would vote for alternative A of the directive.

Chairman Martin said he also favored alternative A, for essentially the same reasons as those for which he had advocated no change in policy at the Committee's previous meeting. It was his impression from the go-around that all of the voting members favored that alternative, with the possible exception of Mr. Maisel. He proposed that the Committee vote on a directive consisting of alternative A for the second paragraph and a first paragraph in the form submitted by the staff.

Mr. Maisel remarked that while he had spoken earlier in favor of different language for the directive, he concurred in the approach advocated by at least half of the members today to let interest rates decline if credit market pressures were in that direction. Because he did not want to disassociate himself from the views of those members he planned to vote favorably on the directive.

> 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 indicates that the pace of expansion in real economic activity was sustained in the third quarter by an acceleration of inventory investment, which about offset a further slackening in growth of private final sales. Slower over-all growth is projected for the fourth quarter, although some cross-currents have been evident in the recent behavior of monthly economic measures. Prices and costs are continuing to rise at a rapid pace. Most market interest rates have declined considerably on balance from their recent highs, in large part because of changing expectations. In the third quarter, average monthly bank credit declined and the money supply changed little; in October it appears that bank credit is decreasing further on average but that the money supply is growing somewhat. In recent weeks the net contraction of outstanding large-denomination CD's slowed markedly, apparently reflecting mainly an increase in foreign official time deposits, but flows of consumer-type time and savings funds at banks and nonbank thrift institutions appear to have remained relatively weak. The U.S. foreign trade surplus increased further in September, but the deficit in the over-all balance of payments was still large on the liquidity basis and even larger on the official settlements basis. The appreciation of the German mark since the end of September, culminating in the revaluation of the official parity, has led to a partial reversal of speculative flows, and conditions in the Euro-dollar market have eased. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

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

Chairman Martin then noted that the Committee had planned to consider today the question of its meeting schedule for 1970. He asked Mr. Holland to comment.

Mr. Holland observed that in a memorandum dated September 29, 1969,[1/] the Secretariat had presented three alternative types of schedules and commented on the pros and cons of each. Schedule A, which called for fourteen meetings a year, was similar to those the Committee had followed in recent years. Schedule B called for twelve meetings a year, mostly on the third Tuesday of the month, and involved four or five 5-week inter-meeting intervals each year. Schedule C called for thirteen meetings a year, generally at 4-week intervals.

Mr. Daane said that for several reasons he had a strong preference for schedule B, calling for twelve monthly meetings. First, the demands being placed on the staff had been steadily increasing. This morning, for example, Mr. Morris had suggested that greater emphasis be placed on formulating policy for the longer run. While he (Mr. Daane) sympathized with that view, it was clear that if the Committee were to undertake to do so on a regular basis the burden on the staff would increase further. Secondly, shifting to a twelve-meeting schedule would reduce the number of occasions on which Committee members and staff invested time and energy in meetings that did not need to be held; he considered today's meeting to be a good illustration of the point.

1/ A copy of this memorandum, which was entitled "FOMC meeting schedules for 1970 and later years," has been placed in the files of the Committee.

Finally, he thought there was merit in the argument that monthly meetings held at about the same time each month would have advantages in that there would be a relatively uniform and reasonably complete body of data for the previous month before the Committee at each meeting. It would be understood, of course, that interim meetings could always be called if circumstances warranted them.

Mr. Daane noted that the Secretariat's memorandum listed as a possible disadvantage of a monthly meeting schedule the fact that it would involve four or five 5-week intervals each year, and would thus lengthen somewhat the average time period for which the Committee formulated policy at each meeting. He personally did not see why that was a disadvantage. The memorandum also suggested that--because members' statements in the go-around often reflected their reaction to issues raised at the preceding meeting--longer inter-meeting intervals would tend to increase the "internal lag in the operations of the Committee." That problem would be considerably less important if the format of the meetings was changed to permit a greater amount of interchange of views. On that as well as other grounds, he thought it would be desirable to consider ways of providing more flexibility in the Committee's discussions.

Mr. Hayes said he agreed entirely with Mr. Daane's observations, and would add a few comments. He was impressed by the points made in the Secretariat's memorandum regarding the advantages of a monthly schedule on grounds of available data, and regarding the advantages of some reduction in the number of meetings in producing a better perspective in staff reports and Committee deliberations. He agreed with Mr. Morris that it would be desirable for the Committee to consider policy for a longer period, and he thought a review of the format of meetings would be helpful in that connection as well as in the one Mr. Daane had suggested.

Two other advantages of the monthly schedule were worth noting, Mr. Hayes continued. First, that schedule would be considerably better than alternative A--the present type of schedule--and somewhat better than C--the four-weekly schedule--in minimizing the number of meetings held during periods of even keel associated with Treasury refundings. Schedule B was not perfect in that regard, since some meetings would be called for around the announcement dates for refundings. However, it tended to avoid meetings during periods in which the subscription books were open. Finally, a third-Tuesday schedule would tend to avoid the conflicts with the Basle meetings that would frequently arise under both of the other alternatives. While only a few participants in Committee meetings were subjected to the strains that such conflicts created, he thought that consideration deserved some weight.

In concluding, Mr. Hayes noted that a third-Tuesday schedule was now feasible because the Federal Advisory Council had expressed willingness to shift its regular meeting dates to first Fridays. He hoped the Committee would take the opportunity provided by the Council's decision to adopt schedule B.

Mr. Brimmer commented that in the past he had expressed some reluctance to shift to a monthly schedule because he thought there were important disadvantages in five-week inter-meeting intervals at the frequency that would be involved. While he still considered frequent long intervals to be a disadvantage, he was prepared to accept schedule B if that was the preference of other members. He agreed that the Committee should give some weight to the desirability of minimizing the number of meetings held during even keel periods, although he would not limit that consideration to Treasury refundings.

If the Committee adopted a monthly schedule, Mr. Brimmer said, he would hope that the staff would put the time so freed to good use. Specifically, he thought it would be helpful to the Committee if the staff presented chart shows like that of today more often--perhaps every third meeting.

Mr. Maisel noted that schedule B involved only one less meeting each year than C, the four-weekly schedule. At the same time, it introduced a relatively large number of 5-week intervals.

While he did not feel strongly on the matter, it was not clear to him why the Committee had to move to the extreme represented by B. He would prefer adopting schedule C, on the grounds that it would offer many of the advantages seen in B and would represent much less of a break with tradition.

Mr. Clay said he also would favor C, partly because he thought the monthly schedule would involve too many 5-week intervals. In addition, he had some question about the argument that B was preferable from the point of view of data availability. If the Committee met at about the same time each month, those monthly statistics which were regularly released shortly before the meeting. date were likely to get undue attention in the Committee's deliberations, at the expense of data released much earlier in the inter-meeting periods.

Mr. Robertson remarked that he had no strong preferences between B and C. He did think, however, that there would be disadvantages in reducing the number of meetings from fourteen to twelve in 1970, which was likely to be a difficult year for monetary policy. As far as the burden on the staff was concerned, some of the comments in the discussion thus far suggested that it might be increased rather than reduced by a shift to a monthly schedule. On balance, he thought it would be desirable to adopt C, the thirteen-meeting schedule, for 1970 and see how it worked out. If no particular problems arose he would not object to considering a twelve-meeting schedule for later years.

Mr. Mitchell remarked that the nature of the proceedings at meetings seemed to him to be far more important than the question of their frequency. In his judgment the sessions were much too long at present. He would favor abridging the length of at least some meetings by shortening the agenda. It might also be desirable for the staff to cut back on the size of the green book. As to the question of frequency, he thought there were important advantages in having the Reserve Bank Presidents and the members of the Board meet relatively often, and also advantages in public awareness of the fact that they did so.

Mr. Hayes noted that he had not heard any criticism from outside observers of the reduction in recent years--from about eighteen to fourteen a year--in the number of scheduled Committee meetings.

Mr. Brimmer observed that, as he had indicated earlier, he did have some continuing concern about the frequency of 5-week intervals under the monthly schedule, and he thought Mr. Robertson's comment had merit. He also noted from the Secretariat's memorandum that the staff's views were divided between schedules B and C. On balance, he was now inclined to favor schedule C if the staff felt that such a four-weekly schedule would not pose serious problems for its work.

Mr. Partee commented that from the staff's point of view either B or C would be a substantial improvement over A, the present type of schedule; it was in connection with the 3-week intervals in the latter that the staff had experienced the greatest difficulty. In his judgment the choice between B and C depended mainly on a decision by the Committee as to whether it was willing to have four or five 5-week intervals each year.

Mr. Sherrill asked whether there were grounds for preferring either B or C from the point of view of the Desk's operations.

Mr. Holmes replied that there would not appear to be any major difference between the two from his standpoint. However, Mr. Coombs no doubt would find B preferable, since it would avoid the burden placed on him when Committee meetings were held on the day following meetings in Basle.

Mr. Sherrill then said he would favor some lengthening in the average intervals between Committee meetings. When meetings were held too close together an erroneous impression was created that the Committee was attempting over-fine control.

Mr. Hayes asked whether a monthly meeting schedule would not have some advantages from the staff's standpoint.

Mr. Partee replied that in some respects the staff's work would be facilitated under schedule B. For example, the fact that the blue book would be prepared at the same time each month would probably prove helpful in developing the bank credit projections, and it should be possible to include projections for both the current and coming months in each issue of the blue book. At the same time, he had some sympathy for Mr. Clay's point that under a monthly schedule some economic series were likely to get more attention than others, which would regularly be close to one month old at the time the Committee met.

Chairman Martin then proposed that the Committee agree that its tentative schedule for 1970 should be that shown under the heading "C-four weekly" in the Secretariat's memorandum. If the resulting reduction in the frequency of scheduled meetings from fourteen to thirteen a year was found to pose no particular problems, the Committee might plan on moving to a monthly schedule in later years.

No objections were raised to the Chairman's proposal.

The Chairman then indicated that the Board had been considering possible regulatory action in the area of commercial paper issuance by bank affiliates and that it would be considering that question further at its meeting this afternoon. He indicated that it would be helpful to the Board to have any views that the Reserve Bank Presidents might care to express.

A number of Presidents offered comments on the subject, and the Chairman remarked that their views would be kept in mind during the Board's discussion later today.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, November 25, 1969, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) October 27, 1969

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on October 28, 1969

FIRST PARAGRAPH

The information reviewed at this meeting indicates that the pace of expansion in real economic activity was sustained in the third quarter by an acceleration of inventory investment, which about offset a further slackening in growth of private final sales. Slower over-all growth is projected for the fourth quarter, although some crosscurrents have been evident in the recent behavior of monthly economic measures. Prices and costs are continuing to rise at a rapid pace. Most market interest rates have declined considerably on balance from their recent highs, in large part because of changing expectations. In the third quarter, average monthly bank credit declined and the money supply changed little; in October it appears that bank credit is decreasing further on average but that the money supply is growing somewhat. In recent weeks the net contraction of outstanding large-denomination CD's slowed markedly, apparently reflecting mainly an increase in foreign official time deposits, but flows of consumer-type time and savings funds at banks and nonbank thrift institutions appear to have remained relatively weak. The U.S. foreign trade surplus increased further in September, but the deficit in the over-all balance of payments was still large on the liquidity basis and even larger on the official settlements basis. The appreciation of the German mark since the end of September, culminating in the revaluation of the official parity, has led to a partial reversal of speculative flows, and conditions in the Euro-dollar market have eased. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the reduction of inflationary pressures, with a view to encouraging sustainable economic growth and attaining reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

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

Alternative B

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

ATTACHMENT B

Simulated Effects of Assumed Alternative Rates of Monetary Expansion[1/]

Projected Annual[2/] Rates of Change in M	Projected I/1970	Projected II/1970	Projected III/1970	Projected IV/1970
0 Per Cent until Jan. 13 then 3 per cent				
Rate of Change in Y	3.0	2.2	2.8	4.2
Y*	- 1.7	- 1.9	- 0.7	1.3
P	4.7	4.1	3.5	2.9
Unemployment Rate	4.5	4.9	5.4	5.7
3 Per Cent beginning now[3/]				
Rate of Change in Y	3.9	3.7	4.2	4.8
Y*	- 0.8	- 0.5	0.5	1.6
P	4.7	4.2	3.7	3.2
Unemployment Rate	4.5	4.8	5.2	5.4

Key to Abbreviations:

Y = Nominal GNP
Y* = Real GNP
P = GNP Price Deflator
M = Money Supply (demand deposits and currency in the hands of the public)

1/ Simulated effects reflect only monetary and fiscal actions. Other factors affecting GNP are assumed unchanged.
2/ Annual rate is compounded from IV/1969 to IV/1970. Government expenditures are assumed to grow at a 3 per cent annual rate during this period.
3/ Three per cent annual rate of change in M beginning with the month of November 1969.

October 27, 1969