MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, July 27, 1971, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Kimbrel
Mr. Maisel
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Coldwell, Eastburn, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Heflin, Francis, and MacLaury, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and Minneapolis, respectively

Mr. Broida, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Garvy, Scheld, Solomon, Taylor, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Kenyon, Deputy Secretary, Office of the Secretary, Board of Governors
Messrs. Altmann and Leonard, Assistant Secretaries, Office of the Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors

Messrs. Coyne and O'Brien, Special Assistants
to the Board of Governors
Mr. Chase, Associate Director, Division of
Research and Statistics, Board of Governors
Messrs. Wernick and Williams, Advisers,
Division of Research and Statistics,
Board of Governors
Mr. Keir, Associate Adviser, Division of
Research and Statistics, Board of Governors
Mr. Gemmill, Associate Adviser, Division of
International Finance, 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
Miss Orr, Secretary, Office of the Secretary,
Board of Governors

Mr. MacDonald, First Vice President, Federal
Reserve Bank of Cleveland
Messrs. Parthemos and Craven, Senior Vice
Presidents, Federal Reserve Banks of
Richmond and San Francisco, respectively
Messrs. Bodner, Willes, Hocter, Andersen, and
Green, Vice Presidents, Federal Reserve
Banks of New York, Philadelphia, Cleveland,
St. Louis, and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve
Bank of Minneapolis
Messrs. Fieleke and Geng, Assistant Vice Presidents, Federal Reserve Banks of Boston and
New York, respectively

Chairman Burns said he was pleased to welcome Mr. Bruce MacLaury, who was attending his first meeting of the Committee in his capacity as President of the Federal Reserve Bank of Minneapolis. The Chairman observed that Mr. MacLaury had served with distinction at the Treasury Department and earlier at the Federal Reserve Bank of New York.

The Chairman then recalled that at the previous meeting he had referred to the fact that the Board was again considering Regulation Q and would welcome the views of Reserve Bank Presidents. Several Presidents had responded with letters that were highly useful, and it would be helpful to have the views of other Presidents who wished to communicate them to the Board.

Chairman Burns then noted that he expected to have two special items listed on the agenda for the next meeting of the Committee, which was tentatively scheduled for August 24. In making their travel plans the Presidents might want to keep in mind the possibility that that meeting might continue well into the afternoon.

Of the two items, the Chairman continued, one involved a possible change in the form of the Committee's directive to the Desk. A number of members were dissatisfied with the present procedure of placing main emphasis on rates of growth of the monetary aggregates or on levels of the Federal funds rate, and some had come to believe that the directive should emphasize member bank reserves--the one magnitude which the Desk could control more or less directly. While there might be differences of opinion on that point, he thought all members would agree that the Committee's present procedures had not worked very well in recent months. As the members would recall, at the June 8 meeting he had asked the directive committee--Messrs. Maisel, Morris, and Swan--to work with the staff on a reexamination of the desirability of emphasizing bank reserves. The report the directive committee had originally submitted, in March 1970, had recommended use of a reserves target, and it was his impression that that recommendation had not been fully considered by the Open Market Committee.

The second item, the Chairman observed, related to the matter of outright operations by the System in the obligations of Federal agencies. At present the Desk was authorized only to make repurchase agreements in agency issues. The Committee had last discussed the question of whether to authorize outright purchases and sales at its meeting on April 6, 1971. However, it had postponed a final decision because of a judgment by the Treasury that a System decision to launch outright operations would reduce the chances of enactment of legislation being prepared by the Treasury that would permit some consolidation of agency issues. However, the time was now approaching when the Board would be sending its housing study to the Congress; indeed, inquiries were being received regularly about the progress of that study. He did not know what conclusions would be suggested by the staff or reached by the Board; the problem was a very difficult one. But the initiation of outright operations in agency issues was a step the Federal Reserve could take, and one that Congress had been urging it to take for some time. There was some feeling in Congress that the System had been uncooperative and had shown little or no interest in the problems of housing. Although he had not definitely made up his mind on the matter of outright operations in agency issues, he leaned in the direction of authorizing such operations. While he suspected that that action would not result in any great benefit to housing, it would demonstrate a cooperative attitude on the part of the System. At any rate, he would ask the staff to review the materials which had been provided to the Committee earlier to see whether they needed updating or other modifications.

Mr. Mitchell observed that the Committee presumably would also be supplied with a new memorandum on the subject of the directive. He would hope that the necessary memorandum would be available early enough to allow adequate time for study; specifically, he thought it should be available at least two weeks before the August 24 meeting.

Mr. Maisel said the directive committee would try to meet that schedule.

Mr. Mitchell then remarked that if it should prove impossible to distribute the memorandum by that time he would suggest deferring the Committee's discussion. Mr. Hayes concurred in Mr. Mitchell's observation.

Chairman Burns said he was sure the suggested schedule could be met.

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee on June 8 and June 29, 1971, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on June 8 and June 29, 1971, were accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period June 29 through July 21, 1971, and a supplemental report covering the period July 22 through 26, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Bodner said the general atmosphere in the exchange markets was, if anything, worse than it had been one month ago. Hopes for an early resolution to the crisis had faded and the market was coming increasingly to see the present situation as a crisis of the dollar rather than of the German mark. That was reflected both in the atmosphere of gloom that hung over the exchange markets and, more specifically, in exchange rate developments and flows of funds. With interest rates rising somewhat here, the differentials vis-a-vis the European markets had narrowed significantly, thereby easing the pressure on the dollar from that source. At the same time, however, that had brought into even sharper focus the underlying and more general U.S. balance of payments problem; for despite the shift in the interest rate constellation, the United States was still running very sizable deficits. Moreover, recent data on the trade position, and the relatively poor outlook for U.S. trade, had reinforced concern about the U.S. situation. Against that background the markets were waiting not only for a German revaluation, but also for other moves--such as an agreement on wider margins by the European Economic Community or other adjustments. The uncertainties had been reflected in current exchange rate developments and in the gold market, where there had been a sharp rise in price to nearly $42 this morning and an increase in professional buying.

Mr. Bodner commented that the increasing tendency of the market to focus on the broader question of the U.S. position would be reinforced shortly by the repayment on August 9 of $1,227 million to the International Monetary Fund by France and the United Kingdom. Included in the package of currencies to be used would be $618 million of Belgian francs and Dutch guilders; and the Treasury would make a simultaneous drawing of those currencies from the Fund to absorb the dollars from Belgium and the Netherlands. In effect, one-half of the British and French debt would be shifted to the United States. Moreover, at about the same time the Treasury would pay off its $100 million special swap with Belgium, thus further reducing the over-all U.S. reserve position.

As the Committee members knew, Mr. Bodner said, the Germans had begun selling dollars in early June. In late June and early July the German money market tightened and the dollar sales tapered off, except for a brief bulge in conjunction with a large block of forward maturities in early July. At mid-month the German Federal Bank made a decision to push the dollar rate through the level at which it had been held, in an effort to unload more dollars in the face of July forward maturities totaling nearly $2-1/4 billion. Although total spot sales of dollars since early June had, in fact, more than offset all of the outstanding forward commitments, German authorities did not wish to see their reserves start rising again during the period of the float. As expected, the market had tended to retreat to see how far the Federal Bank would go. Nevertheless, some $1.2 billion had been sold in July, bringing total sales to about $4 billion, against total forward maturities of $2-3/4 billion. The mark rate was now some 5-1/2 per cent above the old parity and the market expected it to move still higher. Expectations about the future revaluation of the mark were set at about the 6 to 7 per cent range, although there were some rumors running up to as high as 10 per cent. In any case, that there would be a revaluation was no longer doubted by anyone, and even the Germans had given up seriously talking about a return to the old parity.

Meanwhile, however, the Germans had moved to curb borrowing abroad by nonbank firms, Mr. Bodner continued. As the members knew, such borrowing had been a major factor in the initial development of the exchange crisis, and the willingness of the Germans finally to take measures to curb such inflows was a significant step forward. The route was to be the imposition of a reserve requirement on foreign borrowing that was not associated with trade. The measure would be retroactive to July 21. There had been extensive public discussion of the terms of the proposed new legislation and of the fact that it would be made retroactive. Consequently, during late June and early July there was a substantial build-up of new foreign borrowing. That no doubt accounted in part for the difficulty that the Federal Bank had encountered in selling dollars earlier this month. It was clear that the terms of that legislation were such that it would limit only a portion of the total borrowings and that the banks were already working out ways to get around it.

Mr. Bodner noted that the new legislation was expected to go to Parliament in October and it seemed unlikely that a new par value for the mark would be set prior to that time. Any possibility of an earlier reestablishment of parity had pretty much faded with the inability of the German and French Governments to reach agreement on wider bands for exchange trading. The Germans had insisted on a widening of the margins as a precondition for setting a new parity; the French wanted no widening, and in any case no discussion of the subject before the reestablishment of the par value for the mark. It now seemed unlikely that that impasse would be broken prior to the IMF annual meeting, or if it was, that any action would be taken before that meeting.

There had, however, been rumors of an impending agreement, Mr. Bodner observed, and those rumors had sparked a speculative flow into France. At first the inflow had reflected mainly changes in leads and lags in payments for foreign trade, but in recent weeks there had been a distinct element of foreign speculation. The guessing was twofold: first, that there would be a revaluation of the French franc; and second, even if there was no revaluation, that the franc would inevitably move up within whatever wider band might ultimately be agreed upon. So far the French had taken in $900 million in July, and they expected to make substantial further gains before the month was out. The French might well be asking the United States to convert dollars into gold in the near future; they had indicated earlier that they were prepared to hold up to $1 billion uncovered, and their holdings were likely to move well above that level. The French had taken various measures to reduce the incentive for money to come in and to neutralize the impact on domestic liquidity of the existing inflows, but the speculative atmosphere persisted.

Mr. Bodner said the deteriorating climate in the exchange markets had pulled along the guilder and the Belgian franc, and the Swiss franc also had strengthened. The Belgians had taken in some $65 million this month and the System had made an equivalent amount of new drawings on the swap line, bringing the total outstanding up to $405 million.

Sterling had been pretty much on the sidelines, Mr. Bodner commented, with the rate holding firm and the Bank of England making occasional dollar purchases. However, sterling was clearly vulnerable, given the high rate of domestic inflation and the large amount of hot money presently in the reserves. Thus, although sterling was benefiting from the weakness of the dollar, it would not take much of a shift in atmosphere for the British to suffer rather large reserve drains in a relatively short period.

The other major currencies--the yen, the Canadian dollar, and the lira--remained strong, Mr. Bodner said. Japanese dollar purchases this month had totaled almost $700 million. Today the Japanese had cut their discount rate by 1/4 of a point to 5-1/4 per cent and had introduced some fiscal measures designed to reflate their economy. However, it would take some time for those measures to affect the Japanese trade surplus, which was running at an annual rate of about $6 billion.

While he was afraid this was a rather gloomy picture, Mr. Bodner remarked, he thought it accurately reflected the present state of the exchange markets. The next few weeks might be another period of relative calm, but it was unlikely that the exchanges would return to anything approaching normalcy before some major decisions were taken; and there was still a significant risk of another and even more severe explosion.

> By unanimous vote, the System open market transactions in foreign currencies during the period June 29 through July 26, 1971, were approved, ratified, and confirmed.

Chairman Burns noted that several System people had recently attended meetings abroad. He invited Messrs. Daane and Hayes to comment on the meetings in Basle they had attended.

Mr. Daane observed that the standing committee on the Euro-dollar market had met on Saturday, July 10, and the results of their meeting had been discussed at the Sunday afternoon session of the governors. Three problem areas had been reviewed. The first of these, which was discussed at considerable length, concerned central bank swap transactions with their own commercial banks. The bulk of the swaps was accounted for by two countries, Japan and Italy; and it appeared that the volume outstanding might total $3 to $3-1/2 billion, or roughly as much as the volume of direct placements in the Euro-dollar market by central banks of the Group of Ten. The motivation for such swaps was not wholly clear, but apparently they were used as a means to affect domestic liquidity, to provide better financing terms to importers, and to improve the liquidity positions of commercial banks while leaving with them the burden of exchange risks. There was a difference of opinion as to whether the swaps had an effect on the Euro-dollar market. The Japanese and Italian representatives were asked to prepare supplementary reports, for consideration at the September meeting, regarding the effects they thought the swaps had both on the Euro-dollar market and on their domestic markets. The feeling was widespread that even if the swaps did not have the same effects on reserves as did placements in the Euro-dollar market through the Bank for International Settlements, they still had consequences for domestic liquidity not only in the originating country but also in the countries receiving the proceeds.

The second area considered, Mr. Daane said, related to the collection of statistics on central bank placements in the Euro-dollar market. The Dutch had proposed a rather detailed statistical form for reporting central bank positions. However, the French persuaded the group that a simpler form should be used, and it was agreed to proceed on an experimental basis with brief monthly reports. The third area involved the question of whether the agreement by the G-10 countries to avoid new placements of central bank funds in the Euro-dollar market could be generalized to include other countries. It was recognized that there might be difficulties in getting cooperation from the other countries, and further consideration of the question was deferred until September. He might also mention that the Managing Director of the BIS had made some introductory comments about a recent meeting of experts concerning the use of computers in central banks, and had distributed a note on the matter to the governors. A proposal for some form of integration of central bank computers was scheduled for discussion at the September meeting.

Mr. Daane then noted that the Sunday afternoon session had continued with a "tour d'horizon" involving individual country reports. Perhaps Mr. Hayes, who was also present at the meeting, would summarize those reports, after which he (Mr. Daane) might comment briefly on the Sunday evening discussion.

Mr. Hayes said he had found the atmosphere at Basle to be one of continuing unease; most of the representatives seemed to be troubled not only by the problems of their own countries but also by the position of the U.S. balance of payments. The British felt that in one respect fortune had been with them--their reserve position was far more comfortable than had been foreseen. However, they were troubled by the level of unemployment in Britain and by the current rate of advance in prices, which was roughly 9 per cent. The central bank continued to hope that some form of incomes policy would be initiated; but it appeared that the government was more concerned about the problems of getting the economy growing again than about those of checking inflation.

The Canadian representative reported that there had been no dramatic change in the position of his country, Mr. Hayes continued. That position was characterized by low growth rates and high unemployment, and the government and the Bank of Canada were trying to stimulate the economy. Canada had experienced about the same kind of steady rise in wages as the United States had. Their balance of payments, particularly on current account, was very strong, and the Canadian representative admitted that they had received much more special benefit than had been expected from the automobile tariff changes worked out with the United States a few years ago. The German representative noted that the outflow of dollars was reducing the liquidity of commercial banks in his country, and that the Federal Bank was keeping the commercial banks on a very tight rein. Surprisingly, despite an extremely low level of unemployment, Germany was making considerable progress in slowing the rise of wages. In one industry, for example, a recent settlement provided for an increase of only 7-1/2 per cent, compared with a 15 per cent settlement a year earlier. The explanation for that progress was not clear. However, the unemployment rate had risen a little over the past year, and perhaps the attitude of workers was affected by the trend even though the level remained quite low.

According to the Swiss representative, Mr. Hayes said, Switzerland's big problem still was a shortage of labor. The Swiss were generally satisfied with the results thus far of their currency revaluation; developments had gone according to expectations. In France wages were rising at an annual rate of 10 or 11 per cent, and the French representative appeared to be more worried about inflation than he had been a month ago. The Bank of France recently had increased reserve requirements on deposits and also on credits. Reserve requirements on credits were a new instrument, and it was not yet clear how efficacious they were. The Bank was quite concerned about the possibility of large dollar inflows, and had taken some added steps to reduce interest rate incentives to such inflows.

Continuing, Mr. Hayes said the Japanese were still very firmly set against any float or revaluation although they were uncomfortable about the fact that their reserves were continuing to increase rapidly. Japan's real growth rate currently was about 5 per cent--which by their standards was considered a recession--but the Japanese representative expressed confidence that the expansive fiscal and monetary measures now being taken would produce growth approaching the normal rate of 10 per cent. The situation in Italy was quite depressed; industrial production and productivity were declining, unemployment was rising, and the squeeze on profits was greater than in most industrial countries. However, there apparently had been some reduction in social tensions, which perhaps offered some hope in connection with labor disputes. The Belgians were pleased with the manner in which their double exchange market system had been working and thought it was just as well that they had not revalued or floated. The Belgian representative described the current state of economic activity and the balance of payments in favorable terms, but noted that he was troubled about the longer-run outlook mainly because wage settlements currently were providing for increases of around 10 or 12 per cent. The Dutch were less optimistic than the Belgians. The rate of advance in wage rates in the Netherlands had been rising steadily--including wage drift, it was 11 per cent in 1969 and 12-1/2 per cent in 1970, and the present estimate for 1971 was 14 per cent. Their current account was in substantial deficit, and the Dutch representative expressed surprise that the guilder--which had been trading at a premium since revaluation--was considered such a good investment by market participants.

In a concluding observation, Mr. Hayes said he would like to underscore Mr. Bodner's comments regarding the impasse in the bilateral discussions between the French and Germans on the matter of exchange rate policies. Officials of both countries were of the view that there was little chance of resolving their present disagreement before the annual Bank and Fund meetings in September.

Mr. Daane then remarked that the Sunday night discussion of the governors had turned on the subject of exchange rate flexibility. All of the regular BIS representatives had attended the meeting; Mr. Hayes and he had represented the United States. Pierre-Paul Schweitzer, who was present as the guest of honor, was asked to make some introductory comments. He opened the discussion by noting that the Fund had two proposals under consideration. One called for a widening of margins and the other for a temporary or transitional float. Mr. Schweitzer asked that some guidance be given to the Fund regarding those proposals, observing that it would be definitely advantageous to have reached some judgments by the time of the annual meeting of the Fund in September.

Mr. Daane noted that, in response, he had briefly reported that the United States was favorably inclined toward a modest widening of margins--he had not mentioned any specific figures--and that it also looked favorably on a transitional float linked to fundamental disequilibrium. As the discussion proceeded, Mr. Zijlstra pressed hard for agreement on a very modest widening of margins--to a band 1-3/4 per cent on either side of parity--and for a temporary float relating solely to speculative flows without concern about fundamental disequilibrium. He (Mr. Daane) had demurred from that proposal, and he thought it was fair to say that most of the group, including Mr. Schweitzer, considered a 1-3/4 per cent band to be too small. The Canadians suggested a figure in the 2 to 3 per cent range, perhaps 2.5 per cent; and the British suggested 2 per cent. In any case, he thought there was a consensus for some widening of margins. The French refrained from commenting on that subject.

With respect to the temporary float, Mr. Daane said, the majority seemed to favor some sort of formula to deal with speculative flows but not linked to any fundamental disequilibrium. In a concluding comment Mr. Schweitzer had urged once again that the executive directors of the Fund be authorized to go forward on an "as if" basis to see how the proposals might look if implemented.

Chairman Burns then noted that Messrs. Daane and Solomon had attended a recent meeting of Working Party 3. He asked Mr. Solomon to report on developments at that meeting.

Mr. Solomon presented the following report:

> At the Working Party 3 meeting of July 8-9, Germany received considerable attention, not surprisingly. The main point made by the German representatives was that the floating of the mark had enabled the Federal Bank to regain control of monetary conditions in Germany, at a time when aggregate demand has strengthened again after a pause last winter. Meanwhile, a restriction on foreign borrowing by German companies is being proposed for use when Germany ends its float.
>
> Regarding the United States, there was considerable interest in the puzzling combination of rapid monetary expansion and rising short-term interest rates. No criticism of recent U.S. monetary policy was expressed.
>
> The Working Party had before it a new analysis which attempted to examine the underlying balance of payments situation, by correcting the current account balance of the principal countries for the cyclical situation in which they find themselves. This is a procedure similar to computing a "full-employment balance of payments." When this type of adjustment is made, the United States position looks even worse than the actual figures show and the position of the Common Market countries looks stronger, since those countries are experiencing excess demand while the United States is suffering from inadequate demand.
>
> Without going into detail, I can summarize the outcome of the discussion of short-term capital flows as follows: To deal with divergent credit conditions and the resulting capital flows, a variety of measures will be needed. There is no single and simple solution. It is not realistic to expect monetary policies among countries to be coordinated when basic economic conditions differ, but some limited progress may be possible. Some widening of exchange rate margins would be helpful. Beyond this, individual countries should be prepared to apply some form of restraint on the external lending and borrowing by their citizens. The precise form of restraint can vary from country

to country. This is not a very elegant solution but it is probably a realistic one.

Mr. Solomon then said he should inform the Committee that the June trade figures, to be published tomorrow, would show a sizable further worsening in the trade balance. The deficit had increased to a $5.1 billion annual rate in June, compared with a deficit of $3-1/2 billion in April and in May. The net change from the first quarter to the second was $5.3 billion. That was a large shift, and one which had both domestic and international implications.

Mr. MacLaury said he realized that detailed data were not yet available on U.S. foreign trade in June. He wondered, however, whether such data for other recent months suggested any explanation for the recent deterioration in the trade balance.

Mr. Solomon replied that the deterioration seemed to be fairly widespread. Exports of aircraft, which had been sharply higher for a time, had fallen off recently. Imports of automobiles had been rising rapidly, and materials imports had been increasing as business activity expanded. However, there was no single satisfying explanation for the sharp rise of imports in the past few months; that development was puzzling as well as disturbing. In terms of geographical distribution, most of the deterioration had occurred in U.S. trade with Japan and the Western European countries, and little in trade with less developed countries.

Mr. Robertson asked whether any information was available on the extent to which U.S. imports consisted of goods manufactured in foreign countries by affiliates of American firms.

Mr. Bodner observed that staff at the New York Bank recently had undertaken an investigation of that subject. It was too early, however, to report any findings.

Mr. Brimmer remarked that in a contribution to the forthcoming Fiftieth Anniversary Issue of the Survey of Current Business, he discussed the relationship between production of manufactured goods by foreign affiliates of U.S. firms and the export of comparable products from the United States. The analysis indicated that since the late 1950's sales by foreign affiliates of the products covered had grown much more rapidly than U.S. exports of those products. Some of the affiliates' sales represented shipments back to the United States, but he could not say how important those shipments were currently. He understood from conversations with a number of people around the country that shipments to the United States from affiliates in a few countries, especially Mexico, had grown substantially in recent years.

Mr. Brimmer then said he might take a moment to bring the Presidents up to date on the status of the voluntary foreign credit restraint program. The House and Senate had both passed bills relating primarily to the Export-Import Bank. The House version included a provision exempting export credits from the VFCR, and it seemed certain that that provision would be incorporated in the bill reported by the conference committee. It was possible that the legislation as finally enacted would defer the exemption for 90 days, to give the Board an opportunity to make adjustments with respect to the remaining part of the VFCR program. If not, he would propose to the Board that it announce the immediate exemption of export credits, define export credits for that purpose, and ask for a standstill on nonexport financing pending more definitive revisions in the Guidelines. It was quite possible that such an announcement would be forthcoming from the Board late this week or early next week.

In response to the Chairman's request for his recommendations, Mr. Bodner noted that, as he had mentioned earlier, the Treasury would be paying off the $100 million special swap it had with the Belgian National Bank. That was part of an agreement reached with the Belgians under which they had concurred in further three-month renewals of all the System drawings that came up for second renewals during July and August. As the members would recall, the Belgians previously had taken the position that they would not agree to let any individual swap drawing run on for more than six months. Following conversations with Under Secretary Volcker and Mr. Daane, the Belgians had agreed to be somewhat more flexible in the present circumstances. Consequently, the swaps that matured yesterday and today, for which renewal had been approved at the last meeting of the Committee, would run for the full three months; and he now requested the Committee's approval of renewals for further periods of three months of four drawings totaling $175 million that matured between August 10 and August 26. Two of those drawings, totaling $80 million, would involve second renewals; the other two would be first renewals. As the members knew, the Belgian swap line had been in continuous use since June 30, 1970, so that express action by the Committee was required under the terms of paragraph 1D of the foreign currency authorization.

By unanimous vote, renewal of the four System drawings on the National Bank of Belgium maturing in the period August 10-26, 1971, was authorized.

Mr. Bodner reported that the System had a drawing of $250 million outstanding on the Swiss National Bank. That drawing had been made on May 19 in conjunction with the arrangements made for pushing out for investment in the U.S. market some of the funds that had moved into Switzerland prior to the revaluation. Although the Swiss had succeeded in pushing out substantial additional amounts without cover, there had not yet been an opportunity for the System to make any progress in reducing the swap and he requested authority to renew it for another three months. This would be a first renewal.

Renewal of the System drawing on the Swiss National Bank was noted without objection.

Mr. Brimmer raised a question at this juncture about the release of the 1966 minutes of the Committee, which contained the type of material now incorporated in the memoranda of discussion. It was his recollection that in late 1969 or early 1970, when the Committee had authorized the transmittal to the National Archives of the minutes for the years 1962 through 1965, it had been understood that corresponding materials for subsequent years would be made public on an annual basis with roughly a five-year lag. The public's reaction to earlier releases had been quite favorable, and he hoped the Committee would hold to an annual schedule. He suggested that the staff be asked to undertake the necessary preparations for making the 1966 minutes public before the end of the year.

Mr. Coldwell noted that certain passages that were considered sensitive had been withheld when the 1962-65 minutes were released. He asked whether a review would be made of the 1966 minutes to determine whether they contained similar passages.

In response to the Chairman's request for comment, Mr. Broida noted that earlier releases had followed a rather erratic schedule. Thus, the minutes for the years 1936 through 1960 had been sent to the Archives in 1964; those for 1961 in

1967; and those for 1962 through 1965 in January 1970. As he recalled, the Committee had not made a formal decision to release minutes on an annual schedule in the future, but he thought there had been a general supposition that it would follow such a schedule. Acting on the basis of such a supposition, the staff had already undertaken a review of the 1966 minutes; in particular, the New York Bank staff had proceeded quite far in identifying potentially sensitive passages in the foreign currency area and in discussing those passages with the foreign central banks involved. However, the staff was not in a position to make specific recommendations to the Committee regarding the 1966 minutes, mainly because of pressures of other work in the Secretary's Office. He would expect such recommendations to be forthcoming some time this autumn, and certainly before the end of the year.

Chairman Burns noted that he had not been a member of the Committee at the time earlier minutes were released and was not familiar with the issues involved. However, he was instinctively a little disturbed by the reference to deletions. If deletions were to be significant, it might be better, in his judgment, to withhold the minutes until they could be released in full.

Mr. Bodner recalled that in the 1962-65 minutes deletions had been only in accordance with certain well-defined guidelines. Each deletion was identified in the published materials, and the general nature of the material withheld was described in a footnote. Also, as indicated in a note to the minutes for each year, it was anticipated that the passages withheld would be reviewed from time to time to determine whether they could be released.

Mr. Broida added that the number of passages withheld was relatively small, and most were quite brief. The majority of the passages withheld contained information that had originally been received in confidence from foreign central banks or governments and that the foreign authorities still considered to be sensitive.

The Chairman then called for the staff report on the domestic economic situation, supplementing the written reports that had been distributed prior to the meeting. Copies of the written reports have been placed in the files of the Committee.

Mr. Partee made the following statement:

> The economic data received over the past month continue to present a mixed picture. Housing starts were strong in June, and the volume of building permits issued suggests the continuation of a high level of starts in the months immediately ahead. New orders in durable goods manufacturing, on the other hand, still show no vigor; June order volume dropped slightly, even after allowance for the inevitable decline in steel. Industrial production rose moderately further in June, and over the past three months there has been a broadening out in the areas of

expansion. But employment conditions remain quite weak. The sharp and unexpected drop last month in the unemployment rate appears mainly to have been a statistical aberration; non-farm employment declined appreciably also and the insured unemployment rate rose further.

Nevertheless, it seems to me that one can have somewhat more confidence regarding the probable strength of the economic recovery than was warranted a month ago. My reasoning is based almost entirely on the evidence that retail sales have strengthened considerably in recent months, that the personal saving rate has even more room for downward adjustment than we thought, and that business inventories in some lines are now at the point where larger final sales would induce a rebuilding of stocks. If all of these propositions are correct, then we can look forward to a degree of upward momentum in sales, production, and incomes, more in keeping with the usual cyclical experience than we had been projecting.

As for consumer buying, the recent performance looks promising. Retail sales were revised upward for April and May, and the June preliminary figure shows a further significant increase. As a result, second-quarter sales volume is estimated to have risen 3-1/2 per cent from the first quarter--an annual rate of 14 per cent--with large increases in general merchandise and soft goods sales as well as in autos. These gains obviously are a good deal more rapid than could be expected normally on the basis of income growth. Moreover, they appreciably exceed the continuing advance in consumer prices, so that spending has grown over recent months in real terms also. Sales volume in the first half of July, judging from the weekly data, appears to have held at the advanced June level.

The strengthening in retail sales appears to have occurred in the face of continuing relatively pessimistic consumer attitudes. Most of the consumer surveys show only modest improvement thus far in consumer psychology, and one--the weekly Sindlinger telephone survey--has reported marked deterioration over the past two months. But the increase in consumer spending also has come in the face of a continuing very high rate of personal saving. The annual revision in the national income accounts has raised the level of personal saving over the past several years, and the rate is now shown to have been in excess of 8 per cent in each of the past four quarters--the highest ratio in 19 years, and the highest on a sustained basis, except for 1951, of the whole postwar period.

The second-quarter saving rate, at 8.3 per cent, was boosted temporarily by the payment late in June of the retroactive portion of the increase in social security benefits. If that payment were to be excluded from both income and saving for the quarter, on the grounds that it came too late to influence spending appreciably, the saving rate would have been reduced to 7.8 per cent, somewhat less than in the first quarter. Some part of these checks will now be spent, tending to reduce the saving rate in the current quarter. But more generally, it seems reasonable to expect that the historically high saving rate of the past year will not persist, and that consumers will spend relative to income at least as fully as is indicated by the adjusted second-quarter rate.

Business inventories, meanwhile, have been rising this year at a relatively slow pace. Through May, book value had increased at an annual rate averaging only $6-1/2 billion, almost all of which was accounted for by the restocking of auto dealers and by the buildup in inventories of steel and other metals. Manufacturers' inventories, exclusive of metals, have declined appreciably, and trade inventories, exclusive of cars, have shown only moderate net growth. The consequent marked improvement in inventory/sales ratios would appear to foreshadow some restocking need if final sales continue to improve. This will be masked for a while as steel inventories are liquidated in the second half--with or without a strike--and as some further inventory balancing may take place in individual lines, such as automobiles and perhaps business equipment. But the underlying trend in inventory buying should soon be in the direction of increased accumulation.

These are the kinds of considerations that have led us to increase staff projections of GNP growth in the quarters ahead. Compared with four weeks ago, we have raised our consumption estimates considerably and our estimates of inventory accumulation slightly. The saving rate is projected to drop sharply in the third quarter, largely for the technical reason that

I have noted, and then to hold near this lower rate except for a temporary bulge in the first quarter of next year. This pattern does not assume a marked further step-up in consumption relative to income, but rather a slow and gradual improvement beyond the higher spending relationship already achieved.

The effect of these changes is to raise the projection of GNP growth over the next four quarters to $25-1/2 billion, on average, from $24 billion four weeks ago. All of this increase is expected to come in real terms, since price pressures are assumed to be cost-induced. Thus, real GNP is now projected to rise at a 4.6 per cent annual rate over the next four quarters, which is one-half per cent more than in the projection of four weeks ago. This should permit somewhat lower unemployment than we were anticipating earlier; we are now projecting the rate to rise close to 6-1/2 per cent in the fourth quarter and then to drop moderately during the first half of next year.

This seems to me a reasonable upward revision in our projections, given the indications of greater strength in consumer spending. It should be noted, however, that we are still counting on a strong housing performance next year, with starts at a 2.1 million rate in the first half, and also on a continued gradual uptrend in State-local construction expenditures. If financial markets tighten appreciably further, those assumptions could be in jeopardy. Since the lows reached early this year, corporate and municipal bond yields have risen about 100 basis points, the FNMA auction yield on FHA mortgages has increased 80 basis points, and rates on conventional mortgages are commonly reported to be up 1/4 to 1/2 per cent. More important, short- and intermediate-term security yields have risen to the point where they are again competitive with rates paid to savers by the financial institutions; the new 7 per cent Treasury bond may test whether there again is exposure to disintermediation.

We continue to believe that the depositary institutions will experience reasonably large savings inflows in the months ahead, even though the rate of gain is likely to slow markedly from the very strong first-half performance. But the margin of advantage for the institutions is narrowing, and

> further increases in short-term yields could well lead to a larger-than-expected shift in savings flows away from the institutions. This is one reason for seeking to stabilize money market conditions for a while, along with the more technical considerations of even-keel for the Treasury financing. Conditions in the money market have firmed substantially over the past several months, and we are convinced that this--along with the ebbing of transitory factors--will bring a marked reduction of monetary growth rates in the fall. I know how difficult it is to depend on a projection, especially when there is so little evidence of slowing in the current numbers, but I would urge the Committee to hold market conditions steady for a time in order to give the forces already at work on money supply growth a chance to work. This is the logic both of our analysis of the monetary process and of the developing but still uncertain economic recovery that we seek to encourage.

Chairman Burns then called for a general discussion of the economic situation and outlook. He added that the members no doubt had questions they would like to put to the staff.

Mr. Hayes said the staff at the New York Bank viewed the economic situation in almost exactly the same terms as the Board's staff. About the only difference worth mentioning was that they projected the unemployment rate to decline by the second quarter of 1972 to a level about 1/2 point below that projected by the Board's staff. They agreed with the statement in the green book[1/] that recent developments did not promise much progress in the price area.

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

Mr. Hayes then observed that, while long-term interest rates had risen materially since the lows of early spring, they seemed to have been reasonably stable recently despite the further increases which had occurred in money market rates. That was an encouraging development, and it tended to strengthen his belief that monetary policy could make its greatest contribution to stability in capital markets by avoiding any actions that would contribute to inflationary pressures. He had little to add to the comments earlier in today's meeting about the international financial situation. It seemed clear that the U.S. balance of trade and the over-all balance of payments were in an especially critical state.

Mr. Francis remarked that for over a year the objectives of this Committee had been to stimulate real production and thereby to reduce unemployment, while at the same time placing downward pressure on inflation. The recession had been halted, the recovery was progressing, and inflation had receded some. The upswing in activity had been broadly based and pronounced. Most economic time series had indicated improvement since late last year, and revisions had generally been upward as the data became more refined. Reports of those businessmen with whom he had talked had generally been more optimistic than reported economic data indicated. In his opinion, the economy was experiencing a satisfactory expansion, and one that was likely to accelerate in the near future.

On the inflation front, Mr. Francis said, he was less sanguine. The improvement to date had been modest, and it largely reflected actions taken in 1969 and 1970. All experience of which he was aware would indicate that monetary actions taken since January had postponed progress toward achievement of price stability, and if continued much longer, would intensify inflation.

Mr. Francis commented that the Committee might tolerate a temporary postponement of price correction in the interest of promoting a quicker return to capacity output, if that could be successfully accomplished. Again, he was pessimistic, for experience had clearly demonstrated the folly of stop-go policies. For one thing, the effects of the System's actions, particularly on prices, would operate long after the stimulation was withdrawn, just as the nation now continued to suffer from the excesses of 1965 to 1968. For another, once capacity was reached and the excessive stimulation was moderated, spending and production growth would again slow for a period, and unemployment would rise.

Mr. Morris remarked he would like to reinforce Mr. Partee's suggestion that at the current levels of short-term interest rates depositary institutions were close to the point at which another period of disintermediation might begin. Three pieces of evidence in the First District lent support to that view. One was the fact that there had been a marked slowing of inflows of funds to mutual savings banks in New England. For example, during the first five months of the year deposits at Boston savings banks had increased at a 20 per cent annual rate. In June, however, the rate of increase was only 8 per cent, and in the first three weeks of July it dropped to 6 per cent. The local savings bankers were apprehensive about the implications of that slowing. Secondly, in the first two weeks of July there had been a decline in consumer-type time deposits at First District commercial banks. Finally, in June, for the first time since September 1970, New England life insurance companies had experienced an increase in policy loans.

Under those circumstances, Mr. Morris continued, it was important for the Committee to give considerable weight to the impact of monetary policy actions on short-term interest rates. Also, he thought it would be desirable for the regulatory agencies to consider a possible increase in the rate ceilings on consumer-type deposits. It seemed to him that financial intermediaries needed a little more elbow room than they had now with respect to offering rates. A study at the Boston Reserve Bank indicated that since 1967 the margin between the average earnings rates of nonbank intermediaries in the First District and the average rates they paid on deposits had gone up by more than 50 basis points. Thus, it would appear that those institutions could afford to increase their offering rates by at least one-half of a percentage point--a margin that could be important during the next six months.

With respect to large-denomination CD's, Mr. Morris said, he had felt for a long time that it would be desirable to eliminate the ceilings altogether. However, in the present circumstances he did not think such action was urgent. In contrast, he did have a sense of urgency about giving the savings intermediaries a little room to raise their offering rates. As Mr. Partee had indicated, the gains in economic activity projected by the staff were highly dependent on strength in housing, and that in turn depended on the flows of funds into the intermediaries. If those inflows slowed sharply--and if the life insurance companies began to get apprehensive about a new upsurge in policy loans--the volume of new mortgage commitments would inevitably decline. He did not think the economy could afford to lose its main source of vitality.

Mr. Hayes commented that while inflows of funds to New York savings banks were slowing somewhat, on balance they still appeared to be rather vigorous. For example, deposits at the 17 largest mutuals in New York City, which had risen at an annual rate of 19 per cent in the first four months of the year, increased at rates of 12 and 13-1/2 per cent in May and June. In the first half of July such deposits rose at an 8 per cent rate, about the same as a year earlier.

In response to a question by Chairman Burns, Mr. Partee said that as yet there was little evidence at the national level to suggest a marked slowing of inflows of consumer funds to financial intermediaries. The rate of inflow of consumer-type time deposits to commercial banks had diminished in early July, but that could have been a temporary phenomenon related to AT&T's sale of preferred stock rights. He should add, however, that short-term interest rates had risen considerably further since early July, and it was quite possible that that could now have the effect of slowing inflows to the intermediaries more sharply.

Mr. Mitchell asked whether data were available on the relationship between the increase in consumer spending on goods in the second quarter and the rise in imports of consumer goods. Obviously, greater spending did not help strengthen economic activity if it was devoted to imports.

Mr. Partee replied that data for automobiles indicated that unit sales had increased by about 5 per cent from the first to the second quarter and that foreign models had accounted for all of the gain. He did not have corresponding information for other consumer goods lines.

Mr. Solomon remarked that the situation in autos was hardly likely to be typical; he doubted that the marginal propensity to import had reached 100 per cent.

Mr. Eastburn observed that some people had been encouraged by the moderation in the rate of advance of construction wages since the Construction Industry Stabilization Committee was formed a few months ago. He asked whether the Board's staff thought the results of that group's efforts offered grounds for hoping that an over-all incomes policy might be successful.

Mr. Wernick responded that it was difficult to evaluate the results from the reports coming in, but it appeared on balance that construction wages were rising somewhat less rapidly than last year.

Chairman Burns commented that some questions might be raised about the interpretation of the statistics being compiled by the Stabilization Committee. Traditionally, statistics on wage settlements under collective bargaining agreements covered major agreements, affecting 1,000 employees or more. However, the figures released by the Committee covered both major and minor agreements, with the latter dominating. It was his understanding that the settlements under minor agreements characteristically were smaller, so that the data tended to exaggerate the degree of recent improvement. Secondly, a number of the settlements now provided for two wage increases in one year. He understood that in such cases only the first increase was included in the calculations of the rate of advance of construction wages. From conversations with statisticians and with some members of the Stabilization Committee, he thought there had been some improvement in the construction wage picture but not a great deal. Moreover, some members of that Committee were concerned that the improvement might not prove long-lived.

Mr. Partee added that many more of the contracts now being negotiated were one-year contracts than was the case formerly. It was conceivable that whatever improvement was reflected in recent contracts would be lost when they came up for renegotiation a year hence.

Mr. Coldwell asked about the extent to which the wage settlements now being negotiated included open-end cost-of-living escalator clauses.

Mr. Partee replied that such clauses were included in the automobile settlement late last year and in all of the major settlements so far this year except that reached with the postal workers. Of course, there was some variation in the specific terms of the clauses. He did not have any information on the smaller settlements.

Mr. Wernick added that in general a larger proportion of the recent contracts included cost-of-living escalators than had been the case in other recent years.

Chairman Burns commented that the growing importance of open-end escalator clauses also had a bearing on the interpretation of current statistics on wage settlements. The terms of multi-year contracts might seem to call for rather small increases after the first year if no account was taken of such clauses. For comparability, one had to make some assumption about the rate of increase in the cost of living in the future.

Mr. MacLaury noted that according to the blue book[1] the rate of growth in M_1 would decline to 4 per cent in the fourth quarter if the Committee adopted alternative A of the directive drafts.[2] It seemed to him that a good deal depended on the degree of confidence one could attach to that expectation, and he wondered how much confidence Mr. Partee thought was warranted.

Mr. Partee replied that "confidence" was a relative term. Personally, he was reasonably sure that growth in M_1 would slow considerably in the fourth quarter, although he recognized that any such projections were difficult to make. He might note that while the staff had underestimated the magnitudes of the slowdown in growth of M_1 last winter and the acceleration last spring, it had correctly anticipated the direction of those changes. His main reasons for expecting growth to slow in the fall were, first, that the precautionary demand for cash was not likely to persist for long at the high level to which it apparently had risen; and second, that people were likely to become increasingly aware of the increased costs of holding cash that resulted from recent advances in short-term interest rates. Perhaps he should not pursue the matter further at this point, since Mr. Axilrod would be commenting on it at length in his statement later in today's meeting.

1/ The report, "Monetary Aggregates and Money Market Conditions," prepared for the Committee by the Board's staff.
2/ The alternative draft directives submitted by the staff for Committee consideration are appended to this memorandum as Attachment A.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period June 29 through July 21, 1971, and a supplemental report covering the period July 22 through 26, 1971. Copies of both reports have been placed in the files of the Committee.

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

> Short-term interest rates rose across a broad front in the interval between Committee meetings as money market conditions firmed, but long-term markets displayed a good deal of stability. Market reactions to the increase in the prime rate and in the discount rate were relatively mild. There is considerable uncertainty, however, in the market's appraisal of how much additional monetary restraint the System will exercise, and the weekly money supply statistics and Desk actions are under close scrutiny by market participants for the light they may shed on System intentions.
>
> The increase in Treasury bill rates is partly seasonal but also reflects the less easy System policy, heavy foreign bill sales, and the market's expectation that the Treasury will be a heavy seller of short-term debt to finance the large budget deficit over the rest of the year. In yesterday's regular Treasury bill auction, average rates of 5.55 per cent and 5.83 per cent were established for three- and six-month bills respectively, both up nearly one-half of a percentage point from the rates established in the auction just prior to the last meeting of the Committee.
>
> As you know, the books will close tomorrow on the Treasury's August refunding of $5.1 billion maturing debt, of which $4.1 billion is held by the public. Despite relatively high yields, the Treasury is making its first use of the privilege of offering up to $10 billion outside the 4-1/4 per cent interest rate ceiling on bonds by offering a 10-year bond yielding 7.11

per cent, as well as a generously priced 51-month note yielding 7.06 per cent. Although there is a feeling that it was rather skimpily priced, the use of a long-term bond was favorably received by the market as a first step towards recreating a more viable Government bond market and as responsible debt management at a time when there is a large budget deficit to finance. Both new issues are trading at a small premium on a when-issued basis and the refunding should turn out to be reasonably successful, particularly in light of the strong technical position of the market. As a result of a commitment to Congress at the time of the legislation granting a partial exemption from the 4-1/4 per cent interest rate ceiling, the Treasury is also offering the bond to individuals for cash in amounts up to $10,000. The offering has generated a fair amount of interest, particularly in areas where newspapers have highlighted the offering. While a large amount of new money is not anticipated from this source there is a possibility, if the technique becomes standard practice, that in future refundings it may cause problems of disintermediation. The System holds a modest amount--$474 million--of the maturing issues, and I plan to exchange them for the two new issues in a proportion related to the expected public subscriptions.

The Treasury will follow up its refunding operation by auctioning an 18-month note to pick up attrition and to raise a billion dollars or so in new money. Looking ahead, the Treasury will need additional funds before mid-September and has very heavy cash needs in November and December.

Open market operations have been described in some detail in the written reports and I will only touch on them here. Early in the period, when the growth rates of the aggregates briefly appeared to be moderating, operations were aimed at a Federal funds rate in the lower end of the 5 to 5-1/2 per cent range specified at the last meeting. But, as later data indicated greater strength in M_1 than the Committee desired, reserves were supplied more reluctantly and the funds rate moved to the upper end of the range. One complicating factor during the period was the tendency for banks to obtain a greater volume of reserves at the discount window, leaving fewer reserves to be supplied through open market operations. Open market operations also had to take into account a large volume of foreign account activity. The Germans completed their switch into \$5 billion longer-term nonmarketable Treasury securities during the period. This operation involved the sale of over \$2 billion Treasury bills, of which something over half was purchased by the System.

As far as the aggregates are concerned, M_1 appears to be coming on very strongly in July, while M_2 and the credit proxy are showing growth rates well below the path presented in the blue book at the time of the last meeting. At the moment, even-keel considerations would militate against using open market operations to effect much change in money market conditions. Later in the period before the next Committee meeting even keel should be less of a constraint, and it would be helpful to know how much operations should respond to deviations in M_1 alone as compared with the over-all performance of the larger group of aggregates with which we are concerned.

I might add that the markets have generally regarded recent System actions and statements reflecting concern about continuing inflation as constructive for the long run. As I mentioned earlier, however, there is considerable uncertainty in the shorter run as to whether the full effect of the recent moves has already been reflected in the money market or whether some additional firming may be in store. The market, I believe, is prepared to live with a Federal funds rate in the 5-3/8 to 5-1/2 per cent area, but it could react if we were to push into a higher range.

Mr. Robertson asked the Manager to expand on his concluding comment.

Mr. Holmes said he thought that operations by the Desk to keep the funds rate consistently above 5-1/2 per cent would be interpreted as signifying a decision by the Committee in favor of additional firming, and thus would be likely to have an impact on general credit market conditions. How permanent that impact would be was hard to tell, since it would depend on subsequent developments.

He thought it was likely to be felt more in the short end of the market than in the long end.

Chairman Burns remarked that the projected rates of growth in money were likely to play a significant role in the Committee's discussion today. In view of the doubts that some members of the Committee had expressed at various times about the dependability of such projections, he thought it would be helpful to know how the New York Bank's projections of M_1 compared with those of the Board's staff, as shown in the blue book.

Mr. Holmes replied that for July the Bank's estimate of the annual rate of growth in M_1 was a little higher than that shown in the blue book--12.8 compared with 12 per cent. For August and September the Bank's projections were 8.4 and 3.7 per cent, respectively, compared with blue book projections of 6 and 8.5 per cent under alternative A. For the third quarter as a whole the Bank projected growth at a rate a little over 8 per cent compared with the blue book figure of 9 per cent. While the Bank had not yet made a projection for the fourth quarter, like the Board's staff he would expect the growth rate to decline then.

Mr. Daane remarked that in recent years the Committee had tended to take a somewhat more flexible attitude towards even-keel constraints--rightly, in his judgment. He wondered, however, just how vulnerable the market was likely to be at this point to any indications that the System was continuing to press toward firmer conditions in an effort to slow the growth in the aggregates. The Manager had referred to the time later in the coming period when even-keel considerations should be less of a constraint; he would ask just how free the Desk was likely to be at that time to vary money market conditions. In that connection, he noted that according to the blue book the money market firming called for under alternative B would reduce the third-quarter growth rate in M_1 by only one-half of a percentage point--to 8-1/2 per cent. That struck him as a very small difference, given the large margin of uncertainty in the projections.

Mr. Holmes replied that it was difficult to say how long even-keel considerations would remain important in connection with the current financing. It would depend in part on the volume of dealer subscriptions; at the moment dealers probably held a larger volume of rights than they wanted, and while the atmosphere had improved a little today, final information on their takings would not be available until late tomorrow. Secondly, it remained to be seen how long the process of distribution would take. Personally, he thought it would be a mistake for the System to firm noticeably at a time when the dealers were still heavily exposed. It was possible, however, that there would be an opportunity to achieve a modest degree of firming before the payment date if the aggregates were growing at rates considered excessive.

Chairman Burns noted that the Federal Government was running a huge deficit and the Treasury was likely to be engaging in financing operations continually over coming months. For the Committee to take a rigid approach to even keel would be tantamount to immobilizing monetary policy; it was necessary, in his judgment, to interpret even keel flexibly if monetary policy was to play its proper role. He asked whether the staff concurred in that judgment.

Mr. Axilrod said he agreed in general. However, some Treasury financings involved greater problems than others.

Chairman Burns commented that the Committee, of course, could not ignore its responsibilities to the Treasury.

Mr. Swan referred to Mr. Holmes' comment that he planned to exchange the $474 million of maturing issues held by the System for the two new issues in a proportion based on expected public takings. He asked whether there might be advantages in exchanging all of the System's holdings for the shorter issue.

Mr. Holmes replied that the procedure he had mentioned seemed to him to be about as good a rule of thumb for System exchanges as could be devised. Under the arrangements that had been worked out with the Treasury, the way in which the System distributed its takings among the securities offered in a refunding had no effect on the volume of the various issues made available to the public; the Treasury simply issued additional quantities of the new securities in exchange for Federal Reserve holdings of maturing issues in whatever proportions the System requested. From the point of view of portfolio management, the System certainly held adequate quantities of shorter-term securities at present.

Mr. Daane said he would like to return to the subject of even keel. He did not disagree with the Chairman's comments; the question with which he was concerned related to the possible consequences if the market concluded that the Committee was giving less than the usual amount of weight to even-keel considerations in connection with the current refunding.

Mr. Holmes replied that, in his judgment, a market conviction that the Committee was going to tighten policy in the middle of the refunding could seriously endanger the refunding. He would consider even-keel considerations to be more important in connection with the Treasury's current operation, which included a long-term bond, than they were likely to be for the financings later in the year when the new issues were likely to be mostly short-term securities.

Mr. Brimmer noted that the settlement date for the refunding was August 16, only about a week before the next meeting of the Committee. He asked whether the Manager thought it would be possible to accomplish much firming in that week if the Committee were to decide that it would be desirable to move toward somewhat firmer money market conditions.

Mr. Holmes replied that it probably would be possible to do something in that period. In fact, it might not be necessary to wait until the settlement date before acting; it was conceivable that the financing would proceed so well that some move toward firming could be initiated earlier.

The Chairman commented that he believed he expressed the sentiment of a number of Committee members when he said that under current circumstances increases in interest rates were something to be deplored. Indeed, he thought most members would agree that the fundamental need at present was for lower rates. On the other hand, the recent explosive rates of increase in the monetary aggregates were very disconcerting, and they had brought the Federal Reserve under sharp criticism from responsible quarters. The Committee's problem was to slow the growth in the aggregates, and thus far it had not been very successful in doing so. It would be the best of all worlds if it proved possible to achieve more moderate growth along with lower interest rates. The question the Committee was faced with, however, was whether it was prepared to see the Federal funds rate rise a little in the short run as a device for getting control of the aggregates. Rapid growth in the aggregates was causing considerable trouble and if continued would cause even greater trouble; and while he would prefer not to see interest rates rise he, for one, was prepared to accept a somewhat higher funds rate as the price of getting the aggregates under control.

Mr. Maisel expressed the view that the growth rates of the aggregates were only one of the considerations bearing on the Committee's decision today. Another was the question of how much weight should be given to the Treasury refunding--a question that involved major, long-run considerations relating to the techniques employed for underwriting Government securities. For the Federal Reserve to take any action that would call into question the reliability of its tradition of maintaining an even keel during major financing operations could adversely affect the public interest by raising the underwriting costs of future Treasury financings.

Mr. Maisel added that he did not mean to suggest that the Committee could not make any changes in the procedures it traditionally followed during financing operations; it might well decide, for example, that it should shorten the customary length of the period for maintaining an even keel. However, that issue should be considered apart from any particular financing, and the market should be given proper notice of any change in procedures decided upon. It was important, he thought, that the System not change the rules of the game in the course of a financing and without any advance warning to the market.

Chairman Burns asked whether the even-keel tradition was as clear-cut and well-defined as Mr. Maisel's remarks seemed to suggest.

In reply, Mr. Maisel said he thought there was an implicit understanding among the Federal Reserve, the Treasury, and the underwriters that the System would not change policy during the course of a financing.

Mr. MacLaury commented that it was his impression after participating in meetings with the underwriters that they did not consider the even-keel period to have any specific length, or the concept itself to be very sharply defined. He believed the Treasury also considered the concept to be flexible. In his judgment the Committee would not be charged with changing the rules of the game if in the coming period it moved toward firmer conditions to the extent that the market situation permitted. He had intended to raise that point himself because he thought the implication in the blue book that it would be undesirable to act before the settlement date reflected an overly rigid view of even keel.

Mr. Brimmer observed that about two years ago the staff had made an empirical analysis of System operating policies during past periods of Treasury financings. As he recalled the results, they indicated that the even-keel period typically extended from a few days before the announcement date until a few days after the settlement date. Ordinarily the System had not changed policy, either through open market operations or otherwise, during such periods. However, on at least one occasion the discount rate had been changed with disturbing consequences.

Chairman Burns asked whether any deviation in the Federal funds rate from its prevailing level would constitute a change in policy in that sense.

Mr. Brimmer responded the question was not whether the funds rate moved at all but whether it moved in a consistent way. He added that he was sympathetic with the point the Chairman had made. It was his impression that during even-keel periods the rate of growth of reserves had tended to exceed the rate desired by the Committee, and that it had proved difficult after the periods were over to reabsorb the redundant reserves. Thus, the System was likely to find itself financing the Treasury to a greater extent than it intended, particularly in years in which the Treasury was frequently in the market.

Mr. Mitchell said he recalled meetings with dealers in which some had asserted that the System tended to over-protect them during Treasury financings and that they would prefer to fend for themselves to a greater extent.

Mr. Holmes remarked that not all dealers took that position. Moreover, he suspected that some who did so in theoretical discussions might react quite differently in practice.

Mr. Maisel said he agreed with Mr. MacLaury that even keel was a flexible concept. In his view, however, the decision as to whether it was feasible during a financing to implement some change the Committee considered desirable was one that the Manager should make in light of the state of the financing and the market conditions actually prevailing.

Chairman Burns said he was uncertain whether or not his own position corresponded with Mr. Maisel's. He thought it would be a mistake to give the Desk rigid instructions to achieve some change in conditions during a period in which the Treasury would be engaged in a financing. On the other hand, he believed the Committee could appropriately convey to the Manager the sense of its thinking regarding desirable objectives, while granting him a large measure of discretion in deciding how far he could move toward those objectives as the period unfolded.

Mr. Morris said he agreed with Mr. MacLaury's observation that the blue book took too rigid a view of the duration of the even-keel period when it implied that that period would continue until the settlement date. It was not possible to say in advance how long the financing would offer a constraint on operations, since that was a function of the market's ability to "digest" the new issues. The Committee must always be aware, however, that the proper functioning of the Treasury market was critically dependent on the dealers' willingness to take sizable positions in the new issues on very small margins. Like others, he thought the judgment had to be left to the Manager.

Mr. Axilrod commented that the staff had not meant to say that the even-keel period would necessarily last until the settlement date; any such implication in the blue book was a consequence of a poor choice of words. The shortest period during which an even keel had been maintained in the past--in the sense of taking no action that would lead the market to conclude that the System had changed policy--extended from the announcement date through the subscription date. He might note in passing that that period was now longer than it had been earlier as a result of changes in the Treasury's procedures. The Committee had often thought in terms of a period extending through the settlement date or as much as a week or so beyond that date, depending on the difficulty of the financing and market developments. The blue book mentioned the possibility that in the present financing even-keel constraints might persist for a longer period than usual because of the inclusion by the Treasury of a long-term offering.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 29 through July 26, 1971, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on the monetary relationships discussed in the blue book:

The principal point to be made with regard to the policy alternatives presented in the blue book is that both indicate a prospective slowing in the rates of growth in M_1 and M_2. The main reasons for this--given money market conditions--are, one, the likelihood that the apparent unusually large liquidity demands of the past few months will abate as deposit holdings build up relative to other financial assets; and, two, the cumulative impact of recent high short-term market interest rates on the demand for cash and interest-bearing deposits.

There are always uncertainties in these relationships, but, with respect to M_1, we are fairly confident that the direction of change in the rate of growth will be downward. We are less confident with respect to the timing and magnitude of the change. With a Federal funds rate of around 5-1/2 per cent, we are anticipating a drop in the growth rate of money to around 7 per cent over the next two months--with the growth rate about another 1/2 point or so lower if the funds rate were moved up to 6 per cent. In either case we are projecting a further marked slowing in M_1 growth rates later in the year as the continuation of relatively high short-term interest rates intensifies the public's willingness to shift out of cash despite rising transaction demands at that time. This would presage some easing of money market conditions if the Committee were not willing to permit such low growth rates in the fall. But I would like to repeat that, while we think the direction of effect is clear, the timing and magnitude are much less certain and the tempo of the slowdown may well turn out to be more or less rapid than indicated at given interest rate levels.

The financial conditions associated with a slowing of growth in M_1 are also expected to lead to slower growth in M_2 and to continued moderate growth in the adjusted credit proxy. Time and savings deposits other than large-denomination CD's have been weaker than anticipated since mid-year, with the weakness spread through various types of accounts and fairly general across the country. This is puzzling since our reports are that the rate of increase in such deposits at savings and loan associations held up well in early July. Banks might have been hit more than S&L's by payment for the $1.4 billion AT&T preferred stock offering. But another possibility is that the lower net inflows at banks may lead, with some small lag, to a similar change at S&L's--as was the case last spring--and thus may foreshadow some weakening of savings inflows to financial institutions generally, particularly if short-term interest rates rise further.

Bank credit growth will be moderated, of course, by downward shifts in the public's demand for demand deposits and consumer-type time deposits, and banks may not be extremely aggressive in seeking large CD funds or other money-type funds unless business loan demands pick up. The potential for such a pick-up is there, with unused business loan commitments in April (the last date for which we have data) up more than 25 per cent over a year ago. But up to now actual business loan growth has remained negligible. We do, however, expect some boost in bank credit growth over the next two months as banks participate in current and forthcoming Treasury financings and as the U.S. Government to some extent rebuilds its rather low cash balance.

The Treasury financing now under way poses the usual even-keel problem for the Committee. The problem is somewhat exacerbated this time by the inclusion of a long-term bond option in the refunding and by the apparent high degree of sensitivity of the market at the moment to signs of any significant further tightening of money market conditions.

If the staff is correct in its analysis that, given prevailing money market conditions, money growth is likely to slow perceptibly from July to August, then the Committee is not confronted with a serious even-keel dilemma, such as would be the case if money growth were expected to remain at around recent rates over the coming months. Still, the Committee may wish to frame its directive so as to continue to make clear its desire for a diminution of the rapid spring and early-summer growth rates of monetary aggregates, particularly M_1. This could be accomplished through alternative B, which represents a continuation of the language of the directive adopted at the last meeting but with the addition of a reference to the Treasury financing. Either alternative A or alternative B aggregate paths could be attached to the directive.

In either case even-keel considerations would limit the Manager's ability to depart from prevailing money market conditions. But there still might be some room for the Manager to tighten if the aggregates strengthen relative to the acceptable path--whether A or B--by, for instance, at least letting any added money market credit demands in connection with the financing pull the funds rate up to 5-5/8 or, if possible, 5-3/4 per cent. If the aggregates began to weaken significantly relative to path, on the other hand, it might also be desirable to permit the Manager to ease off on the money market in view of the still somewhat uncertain state of the current economic recovery and in case such shortfalls were signaling an earlier and sharper curtailment of money growth than is currently being projected.

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

> To my mind there are two good reasons for maintaining an unchanged stance in monetary policy at the present time. In the first place, the usual even-keel period may extend almost until our next meeting. Given the somewhat uncertain atmosphere in the Government securities market and the fact that our recent discount rate increase occurred such a short time before the announcement date, it would seem clearly appropriate to try to encourage as stable a market atmosphere as possible in the next few weeks.
>
> But apart from this even-keel consideration, I think the general economic and credit situation also argues for stopping, looking, and listening before making any further policy move. We have encouraged and achieved a substantial firming of short-term market interest rates over the past three or four months in our effort to bring about more moderate growth rates for the monetary aggregates. There has been some slowing of the increase in the broad money supply, and the credit proxy has been growing moderately for some time. On the other hand, the latest estimates for the narrow money supply remain at an excessively high level. However, there is reason to hope that this may reflect the usual lags and that we may be seeing lower growth rates in the next few months even though money market conditions may remain about where they are.
>
> The firming of short-term interest rates that has already occurred has unquestionably helped in a major way, along with some interest rate declines abroad, in checking the interest-induced short-term capital flows that paved the way for the May currency crisis. While further firming of the money market might bring some additional benefits in this area, I think that for domestic reasons we have done about all we can afford to do at the moment in the monetary field for the balance of payments and by way of a contribution to combating inflationary psychology. We cannot overlook the fact that the economic recovery is still rather fragile and that unemployment seems likely to drop only very slowly over the coming year.

When I speak of maintaining policy unchanged, I am thinking of keeping money market conditions about where they have been in the past week rather than where they were immediately after our last meeting. I have in mind a Federal funds range of about 5-1/8 to 5-5/8 per cent, with a preference for rates toward the top end of the range and a Treasury bill rate reasonably close to the present level. In a period like this, borrowings are apt to be erratic and should be permitted to swing within a rather wide range. Alternative A of the directive drafts seems quite satisfactory.

I am glad that the Board saw fit to approve the 1/4 point discount rate increase voted by our directors on July 15. It seems to me that it cleared the air somewhat in the markets, was a sound precautionary move to minimize possible future abuse of the discount window, and was a useful signal of our continuing great concern over the inflationary outlook. I would think it desirable and appropriate, in the fairly near future, for the Board to remove the remaining interest ceilings on large certificates of deposit.

My willingness to hold still on monetary policy in no sense implies the absence of great concern over the prospects for continuing inflation and a drastically unsatisfactory balance of payments position. These conditions underline the urgent need for an effective incomes policy. I also believe the time is ripe for a hard look at a new "package" approach to ways of reducing our international payments deficit.

Chairman Burns asked whether he was correct in thinking that Mr. Hayes had interest rates in mind rather than growth rates of the monetary aggregates when he spoke in favor of an unchanged stance for monetary policy at this time.

Mr. Hayes replied that he had had both in mind. He noted that for August and September taken together the Board's staff projected growth in M_1 at an annual rate of 7-1/4 per cent, and the New York Bank staff at 6 per cent, if money market conditions were unchanged. M_1 growth rates of that order of magnitude were acceptable to him, in the light of recent and prospective changes in M_2 and the bank credit proxy.

Mr. Morris said he favored the specifications given in the blue book under alternative A, including the 5-1/2 per cent Federal funds rate. However, he preferred the directive language of alternative B. As the blue book indicated, the language of B was consistent with the specifications given under both alternatives. It seemed preferable to him because its structure was the same as that of the previous directive, and he saw little point in shifting the form of the directive back and forth from one meeting to the next.

There were several considerations underlying his preference for the alternative A specifications, Mr. Morris continued. First, the staff's projection that under unchanged money market conditions growth in M_1 would slow in the second half of 1971 seemed quite reasonable to him. Earlier in the year he had been skeptical about the projections of rapid growth in M_1, to some extent because he had suspected that the staff was overemphasizing the lagged impact of changes in interest rates as a determinant of money growth. However, those earlier projections had worked out quite well; and, as the staff indicated, the interest rate effect would be working in the opposite direction during the latter half of the year. Secondly, he was less concerned about the behavior of the aggregates in June and July than he would have been had he focused solely on M_1. In those two months the bank credit proxy had increased at an average rate of only about 6-1/2 per cent and total reserves at a rate of less than 2 per cent. He thought the Committee should give weight to those aggregates as well as to M_1.

However, Mr. Morris said, his main reason for preferring the specifications of alternative A was the risk that a wave of disintermediation would be set in motion by the firming of money market conditions called for under B, including an increase in the Federal funds rate to 6 per cent. That would be a highly unfortunate development at this stage of an economic recovery which depended so heavily on strength in housing. He was sympathetic to the Chairman's view that recent growth rates in M_1 were causing great difficulties, but he believed that a wave of disintermediation triggered by System efforts to slow M_1 would also cause great difficulties. He would be less concerned about moving toward somewhat firmer money market conditions if, as he had suggested earlier, ceiling rates on deposits at thrift institutions were raised by one-half of a point.

In reply to a question by Chairman Burns, Mr. Mitchell said that at the moment the inter-agency coordinating committee did not have an increase in ceiling rates under consideration.

Mr. Coldwell remarked that he continued to believe that the primary aim of policy at this time should be to control inflation. Some recent System actions, such as the discount rate increase, were helpful in that connection, but he was still greatly concerned about the price outlook. He also foresaw further difficulties ahead in the international financial area. For those reasons he thought that monetary policy should be somewhat more restrictive. It was important that the rate of growth of M_1 be slowed, if only to avoid the effects on market expectations that high growth rates now produced--mainly as a result of the procedures the Committee itself had been following.

Mr. Coldwell then observed that he had some question about the sentence in the staff's draft of the first paragraph of the directive which read "The deficit in the U.S. balance of payments remained extraordinarily large in the second quarter, reflecting capital outflows related to expectations of shifts in foreign exchange rates and the development of a substantial deficit in the merchandise trade balance." He thought the statement would be more accurate if a clause were added to indicate that the capital outflows also reflected international differentials in interest rates.

In response to a request for comment, Mr. Solomon said that the language proposed in the staff's draft was based on an analysis indicating that between the first and second quarters the character of capital outflows had shifted and that speculative movements had become much more important. Differentials in interest rates had, of course been important earlier in the year, but in the period before the early-May crisis rates here and abroad had been tending to converge.

Chairman Burns expressed the view that in the first half of April interest rate differentials were still playing a rather significant role in connection with capital outflows, even though speculative factors became increasingly important over the course of that month as expectations of changes in parities mounted.

Mr. Hayes concurred in the Chairman's view. Like Mr. Coldwell, he thought some account should be taken of interest-induced flows in the directive.

Chairman Burns observed that that purpose could be served either by adding an explicit reference to such flows, as Mr. Coldwell had suggested, or simply by inserting the word "mainly" before the phrase "reflecting capital outflows related to expectations of shifts in foreign exchange rates...."

A majority of the members signified that they would favor the latter amendment of the draft language.

Continuing his remarks, Mr. Coldwell said that, while he thought there was merit in Mr. Hayes' arguments for maintaining a stable policy posture, he was more impressed by the need for policy to continue to move against inflation and to make whatever contribution it could toward improving the current situation. Accordingly, he would prefer the alternative B policy course. He added that he would favor giving the Manager a large amount of leeway in connection with his operating decisions.

Mr. Swan observed that to his mind the growth rates of the aggregates for August and for the third quarter as a whole that were associated in the blue book with alternative A did not differ significantly from those shown under alternative B. In all probability the actions of the Desk during most of the coming period also would not differ significantly if the Committee adopted one alternative or the other. While the choice therefore seemed to be mainly a matter of semantics, he thought it was nevertheless important. He was not aware of any developments during the past four weeks that warranted a change in the policy--as expressed in the previous directive--of seeking to achieve more moderate growth in the monetary aggregates over the months ahead; and in the absence of a change in policy, he thought it would be a mistake to change the wording of the directive. Accordingly, he would prefer alternative B.

With respect to Regulation Q, Mr. Swan said he had some sympathy for the view that it would be desirable to increase ceiling rates somewhat on smaller-denomination CD's. However, he was inclined to doubt that disintermediation was imminent, and he was not sure that it would be desirable to raise those ceilings well in advance of such a development. Like Mr. Morris, he thought action with respect to large-denomination CD's was not urgently required at present levels of market rates. In the case of large-denomination CD's, however, it might be desirable to consider suspending the remaining ceilings now, rather than to wait until there was great pressure to do so.

Mr. Coldwell observed that in his recent letter to Chairman Burns on the subject of Regulation Q he had confined his observations to large CD's, on the assumption that that was the main area of Board interest at present. He asked whether the Chairman would like to have comments on ceiling rates for other types of time deposits.

The Chairman responded that when he had invited written expressions of views from the Presidents at the last meeting he had been thinking primarily about large CD's. However, he had found the more general comments today by Mr. Morris and others to be helpful, and he would be pleased to have supplementary letters from any Presidents who had already commented on large CD's.

Mr. MacLaury said he believed that the risk of aborting the economic recovery had diminished over the past four weeks, and that the Committee could now focus more on the objective of moderating the growth of the monetary aggregates, particularly M_1. The blue book projections shown under alternative A seemed to him to involve an adequate degree of deceleration. Although he was skeptical that the slowing indicated for the fourth quarter would actually be achieved under unchanged money market conditions, he would be willing to go along with alternative A today. However, he would favor placing heavy emphasis on the proviso clause calling for somewhat firmer conditions if the aggregates were significantly exceeding the expected paths, and he would be inclined to give even-keel considerations the minimum weight consistent with the market's understanding of that concept. Also, he questioned the desirability of qualifying the proviso clause with an instruction to take account of developments in capital markets, since he felt that capital markets could be adversely affected by excessive growth in the aggregates as well as by increases in short-term interest rates.

Mr. Mayo remarked that he was philosophically inclined toward the language of alternative A, with its emphasis on money market conditions. By formulating its directives in terms of aggregates the Committee had led the market and the press to judge the performance of monetary policy mainly on the basis of the changes in the aggregates, and it had thus created problems for itself. However, since the Committee would be considering a possible change in the form of its directive at the next meeting he thought it would be a mistake to shift to the alternative A form today.

While he favored the alternative B language for that reason, Mr. Mayo continued, he believed there would be serious risks in pushing the Federal funds rate up into the upper end of the

5-1/2 to 6 per cent range associated with that alternative. Moreover, he did not think there was any need to go that far at this time. He would favor keeping the funds rate within a 5-1/2 to 5-3/4 per cent range, and he would hope the three-month Treasury bill rate would stay within a 5-1/2 to 5-7/8 per cent range.

With respect to the subject of even keel, Mr. Mayo said he agreed the concept should not be applied rigidly. He believed that the System had, in fact, not taken a rigid approach, at least not in many years.

Mr. Clay observed that implementation of the Committee's open market policy following the last meeting had led to a significant increase in the Federal funds rate and an accompanying increase in the Federal Reserve discount rate. Having made that move in endeavoring to restrain the rates of growth in the financial aggregates, it would seem best to continue to operate within that same program for the interval until the next meeting and observe the resulting financial developments. That also would minimize the possibility of unsettling the money and capital markets during the Treasury financing. In the light of all the relevant information available at the time of the next meeting, the Committee could decide then whether it needed to tighten further.

Mr. Clay considered alternative A to be the logical choice for the directive. That applied to its continuation of current policy, its formulation in terms of money market conditions as the primary consideration, and its one-way proviso clause. However, he would have no objection to alternative B since he thought the results of the operations under that alternative would not deviate greatly from what they would be under alternative A.

Mr. Heflin said he was still impressed with the strength of inflationary expectations and with the danger that those expectations could keep interest rates at levels that retarded recovery. So far as he could see, the Committee's recent moves to stem excessive growth in the aggregates had been appropriate. But, given the lagged effects of its actions on the aggregates, the Committee also had to consider the possibility that it could overreact to the rapid second-quarter expansion.

Over the past three months, Mr. Heflin continued, the Committee had firmed money market conditions to a very considerable degree. Happily, it had been able to do that without undue disturbance to long-term markets. So far, he would have to count the visible effects on the aggregates a disappointment. But while M_1 growth accelerated in July, he thought it significant that all the other aggregates were well below the tracking path. Moreover, while he remained skeptical of the blue book projections, he thought there was substance in the staff's judgment that the recent sharp runup in market rates foreshadowed a slackening in M_1 and M_2 in the months ahead.

Under the circumstances, Mr. Heflin said, he was reluctant to push toward further firming at this time. Both economic and even-keel considerations reinforced that reluctance. He would be concerned that a Federal funds rate in the 5-3/4 to 6 per cent range might trigger expectations of another hike in both the prime and the discount rates, with undesirable effects in long-term markets and a definite risk that disintermediation might once again become a serious problem. He would support alternative A.

Mr. Heflin added that he was much impressed with the point the Chairman had made about the need to treat even keel as a flexible concept. He believed, however, that the proviso clause of alternative A was formulated in a way that would permit such an approach.

Mr. Mitchell commented that his expectations for the economy were relatively bearish. He did not agree with the staff on the implications of the recent strengthening of consumer purchases, since much of the increase was probably serving to stimulate imports rather than domestic production. He saw no reason to become optimistic about the outlook for the next six to nine months unless there was evidence--which he did not expect--of a rise in Government spending on defense and space programs or in business spending on capital goods and inventories.

In his judgment, Mr. Mitchell continued, the Committee was being unduly influenced by the behavior of M_1. Both M_2 and the bank credit proxy had increased less than expected in June and July. He might note that it was difficult to evaluate the significance of recent growth rates in those variables in the absence of an analysis of the effects of reintermediation, which he hoped the staff would provide. It was possible, for example, that the decline in the rate of deposit growth at mutual savings banks in Boston from 20 per cent earlier in the year to 6 per cent recently, which Mr. Morris had reported, simply reflected the end of a phase of reintermediation; and that 6 per cent was a perfectly satisfactory growth rate under present circumstances. He personally believed that the recent behavior of M_1 also had been influenced by the reintermediation process, as both individuals and businesses accumulated demand deposits while awaiting appropriate investment opportunities.

Mr. Mitchell went on to say that according to figures in the blue book total reserves had not changed from May to July. In his judgment that constituted too tight a policy; he thought it would be desirable to let reserves grow somewhat at this time. He favored alternative A for the directive, although he would prefer to employ a two-way proviso clause--as Mr. Axilrod had implied might be desirable--rather than the one-way clause shown in the staff's draft. He was disturbed by the fact that many people thought the Committee had adopted an ideology centered on M_1. He was basically an "aggregates" man, but he was not in the least unhappy to formulate the directive in terms of money market conditions from time to time, when circumstances argued for such a course.

Chairman Burns remarked that, according to a text table in the blue book, total reserves had grown at a 6.6 per cent rate in the second quarter and at a 3.1 per cent rate in July. He asked about the basis for Mr. Mitchell's statement that such reserves had not grown from May to July.

Mr. Mitchell replied that Table 1 in the appendix material of the blue book showed total reserves at $31.3 billion in each of the three months during that interval.

Mr. Axilrod noted that total reserves had in fact increased in July--as shown by the data on rates of change in the middle bank of Table 1. The increase was not reflected in the figures in billions of dollars to which Mr. Mitchell had referred because the latter were heavily rounded.

Mr. Mitchell then said his point was simply that, despite all the comments about excessive growth in the aggregates, only M_1 could be said to be misbehaving. As far as total reserves were concerned, he was unhappy about the recent absence of significant growth in light of the economic situation and outlook.

Mr. Axilrod noted that the staff was projecting a rather substantial increase in total reserves in August--at an annual rate of 13 or 14 per cent--in part because of an increase in required reserves expected to result from the lagged effect of July growth in demand deposits.

Mr. Daane observed that, while he would not classify himself as an "aggregates" man, he thought that the System's posture in that respect was important and that it would be desirable to achieve more moderate growth in M_1. He would favor giving the Manager sufficient latitude to do what he could in that connection during the coming period. For the directive he would prefer language similar to alternative A but modified in the direction of B, along the following lines: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining prevailing money market conditions; provided that somewhat firmer conditions shall be sought if it appears that, taking account of the current Treasury financing and of developments in capital markets, more moderate rates of growth in the monetary and credit aggregates can be achieved."

Mr. Daane went on to say that such language would signify that the Committee wanted even-keel considerations applied, but not in a rigid fashion. In effect, the Manager would be instructed to take advantage of any opportunities that might present themselves during the weeks immediately ahead to move in the direction of some moderation of growth in the aggregates. In that connection, he would favor the range for the

Federal funds rate that Mr. Mayo had suggested; like the latter, he would not want the funds rate pushed up to 6 per cent at this time. It was particularly important, he thought, to avoid having stories circulated to the effect that the Committee had instructed the Manager to pay little attention to even-keel considerations during the first Treasury refunding in a long time that involved a long-term bond.

Chairman Burns noted that the Committee's decisions were confidential until the policy records were published three months after the meeting. He asked whether Mr. Daane was concerned about the risk of premature disclosure of today's decision.

Mr. Daane replied that the spirit of the Committee's decision might very well become known soon without suggesting any breach of confidence. In any case, he thought damage would be done by a disclosure in the policy record to be published in 90 days that the Committee had decided to ignore even keel at this time. The kind of directive he proposed seemed to him to be preferable to both of the alternatives the staff had suggested.

Mr. Maisel said he concurred in Mr. Morris' comments. He favored the alternative A specifications in light of the economic situation and the alternative B language on the grounds that the Committee should avoid needless changes in the wording of the directive. Also, as Mr. Mitchell had suggested, it would be desirable to put increased emphasis on M_2, the bank credit proxy, and bank reserves, rather than focusing narrowly on M_1.

Mr. Brimmer said he favored both the specifications and language of alternative A. The growth rates in the aggregates projected for August, September, and the fourth quarter under alternative A suggested that a good deal of the desired moderation was already in train; although M_1 was still growing rapidly in July, it appeared that that month represented a watershed. Since the growth rates anticipated with unchanged money market conditions seemed quite acceptable he saw no need to seek the further moderation called for by alternative B. In his judgment, it would be unfortunate if the Desk were to press the Federal funds rate well above 5-1/2 per cent in the coming period. Although he would not want even-keel considerations to be applied rigidly, he thought the Committee should lean in the direction of the traditional approach in light of the complexity of the current refunding.

In a concluding observation, Mr. Brimmer said he could accept the directive language Mr. Daane had proposed. However, he did not believe that language had any particular advantage over alternative A as drafted by the staff.

Mr. Sherrill said he preferred alternative A as drafted, although he would have no serious objection to the language of alternative B if associated with the specifications of A. He was quite satisfied with the prospective growth rates for the aggregates under alternative A, including the projected increases of M_1 at annual rates of 6 per cent in August and 6-1/2 per cent over the second half of the year. The prospective growth rates for M_2, which were nearly the same, might almost be considered too low. It was difficult to interpret the 11 per cent rate at which the adjusted credit proxy was expected to rise in August because of the effects of reintermediation on that variable, but the 8 per cent rate projected for the second half was satisfactory.

Mr. MacDonald said he agreed with Messrs. Brimmer and Sherrill that the prospective second-half growth rates in the monetary aggregates under alternative A were quite satisfactory. Accordingly, he preferred that alternative. The proviso clause should be implemented if weekly data in the coming period suggested that the aggregates were growing at rates significantly above the targeted paths. Even in that event, however, in light of even-keel considerations he thought the funds rate should be increased only moderately above the 5-1/2 per cent level, in line with Mr. Mayo's suggestion.

Mr. Eastburn commented that he had been quite pleased to hear the discussion earlier today on the need for a more flexible approach to even keel--a discussion which he thought marked significant progress. He favored alternative B for the directive.

There was little difference between the rates of growth in the aggregates projected for the third quarter under A and B; and while the differences in the projections for the fourth quarter were greater, he would hesitate to put too much reliance on projections for a period so far ahead. Short-term market interest rates were expected to be somewhat higher under B than under A, but that did not disturb him since he was less concerned about the imminence of disintermediation than some others were. He believed that the language of alternative B was preferable to that of A, and that the former would give the Manager sufficient leeway in making operating decisions.

Mr. Kimbrel observed that, according to the blue book, the staff anticipated that "the tighter money market conditions assumed under alternative B could lead to a fairly substantial upward interest rate adjustment over the near term." The blue book also suggested, however, that there was "the possibility that a further move toward achieving lower monetary growth rates would over time have a constructive influence on market psychology." It also said it was not clear that the expected near-term upward pressure on interest rates would be long sustained.

Mr. Kimbrel remarked that, although all members of the Committee continued to deplore higher interest rates, higher rates over the near term might be a modest price to pay for accomplishing some constructive influence in controlling the monetary aggregates.

Growth in the monetary aggregates continued to be much too explosive, contributing to consumer fear of unabated inflation.

Mr. Kimbrel said he was not unmindful of the tradition of even keel, and of the fact that the current financing would be especially sensitive to the use of more latitude in even keel. The System certainly would not want to injure its integrity in the eyes of market participants by an ill-timed move. Nevertheless, he preferred alternative B. He would much prefer the language of B even if the aggregative growth paths associated with A were adopted as the expected paths. During this period he would prefer to provide an abundant measure of flexibility to the Desk in accomplishing the desired moderation in the growth of the monetary aggregates.

Mr. Francis said he was alarmed at the 12 per cent annual rate of growth of money since January. It had been widely recognized that the 7.6 per cent rate of money growth in 1967 and 1968 was an excessive response to the 1966-67 slowdown. It appeared that the System would make an even greater mistake if money growth was not slowed soon. He recommended that growth of money be limited to a 4 to 5 per cent annual rate.

Mr. Francis remarked that the rapid growth in money had resulted from both a desire for quick economic expansion and the emphasis since last fall on money market conditions. A quick economic response from monetary actions had seldom occurred; yet, to his knowledge, every experience of prolonged rapid monetary injection had been followed by an intensification of inflation.

In recent months, Mr. Francis continued, concern had been expressed by members of the Committee that monetary expansion might have been too rapid, despite intentions to the contrary. That had led some to conclude that the Committee was not able to control money growth adequately. He attributed the apparent lack of success in controlling money to the method used. Emphasis had been on influencing money market conditions as a means of achieving a desired rate of monetary expansion. Those market conditions had been permitted to tighten somewhat in recent months; at each occasion, however, there had been a fear that a rise in interest rates might choke off the fragile recovery, and the step had been taken very cautiously. It was his belief that interest rates had continued to be held below equilibrium levels by the Committee's massive injection of Federal Reserve credit since January. The growth of those funds had also encouraged inflationary expectations which, in turn, pushed equilibrium interest rates even higher. With current underlying economic conditions and rising inflationary expectations, the result had been higher rates of money growth than the Committee had specified.

Mr. Francis said he would suggest that the Committee stop the course toward greater inflation and higher interest rates now by directly placing stress on achieving moderate growth in the monetary aggregates rather than by making adjustments in money market conditions. In the short-run, interest rates would go up, but not nearly so high as they were likely to go if the recent policy course was continued. The Committee's main responsibility was to promote economic stability, with a much lower priority to be given to conditions in the money market.

Mr. Robertson made the following statement:

> The economic recovery does not yet give signs of being robust. Some of the latest economic news--such as the June weakness in new orders and in the index of leading cyclical indicators--is a little disquieting. But consumer spending was very strong in the second quarter, and there is little reason not to expect continued strength from that sector in the future. This should eventually lead to a further pick-up in production as businesses take a more bullish attitude toward inventories. By the fourth quarter, according to staff projections, demands will be sufficient so that real GNP will begin expanding at over a 5 per cent annual rate, and under those circumstances the economy should be in a position to bring about a significant reduction in unemployment. However, the recent price news tends to confirm the seriousness of the inflationary problem confronting us.
>
> Our long-run interests necessitate that we make certain that the economic recovery is accompanied by further progress in reducing inflation. Some form of incomes policy would be helpful in view of the cost-push pressure behind the inflation. But the prospects for such a policy are not particularly bright as of now. Hence, our problem is a difficult one.
>
> We may have to recognize that under the circumstances price increases are likely to persist longer and to be larger than is desirable, but we do not have to be in the position of actively encouraging inflationary attitudes. We can discourage inflation by holding down on the extent to which the Federal Reserve contributes to expansion in liquidity. Most sectors of the economy have already rebuilt liquidity. They are in a position to increase spending or

lending rapidly once confidence is restored. A continued rapid expansion in money--such as we have had over the past four months--would only increase the risk that inflationary expectations will be enhanced, would probably do little to encourage additional real economic growth, and would lead to future dilemmas much worse in intensity than those with which we are now dealing.

Consequently, I would vote for alternative B. I would interpret it to mean that the Manager would, at a maximum, provide reserves consistent with the slowing in the average rate of growth in monetary aggregates indicated by the alternative A blue book paths. I prefer the alternative B path, however--at least through the third quarter--and would be prepared to see reserve growth confined within those limits if that were not seriously upsetting to the Treasury financing. I am prepared to see much wider week-to-week fluctuations in the Federal funds rate than we have heretofore permitted, in the interest of keeping the growth rate of bank reserves and other monetary aggregates under control; but over the next four weeks, because of even-keel considerations, the scope for funds rate fluctuation presumably would be somewhat limited.

As a footnote, let me urge that we stop "aiming" at a Federal funds rate and instead keep our eye on the extent to which we are adding to the supply of reserves to the banking system, letting interest rates seek their own level within ranges that would preclude disorderly markets.

Chairman Burns noted that the statement he had presented to the Joint Economic Committee last Friday set forth the thinking of the Board in general, and his own thinking in detail, on the state of the economy. Since the members had been provided with copies of that statement there was no need for him to comment today on the economic situation.

However, the Chairman continued, he did want to say a few words about interest rates. The Committee had been reluctant to take actions that would contribute to upward pressures on interest rates because it had recognized the large degree of dependence of the current recovery on continued strength in home building and State and local government construction outlays. Therefore, it had tolerated the very rapid rates of growth in money of recent months. But the Committee's efforts had been frustrated in the market place. The rapid rates of growth in the aggregates--together with the large Federal budget deficit--had alarmed many people, and had been widely interpreted as indicating that the Federal Reserve had joined the Administration in pursuing a highly expansionary economic policy. Interest rates had risen in large measure because of the resulting expectations of renewed rapid inflation, so that the Federal Reserve was in part responsible for their rise. Accordingly, he would very much like to see the growth rates of the aggregates reduced somewhat.

Chairman Burns then observed that it was rather difficult to summarize the views of the Committee today. It appeared that more members favored the specifications of alternative A than those of B. On the other hand, some in the former group preferred the language of alternative B. Personally, he also preferred the language of B, because it was similar to that which the Committee had used in its previous directive. He was not inclined to make substantial changes in the directive language unless the Committee intended to indicate a change in its policy, and he had not detected such an intention in the discussion today.

The Chairman expressed the view that the differences in the specifications of the two alternatives were not very large. It was his impression that some of those who preferred the specifications of A would not be opposed to instructing the Manager to seek a Federal funds rate a little above 5-1/2 per cent if in the Manager's judgment market conditions permitted such action. To determine the sentiment of the Committee, he thought the members might be polled on their willingness to accept a 5-1/2 to 5-3/4 per cent target range for the Federal funds rate.

Mr. Sherrill asked whether the Chairman contemplated including an instruction to the Manager to take account of even-keel considerations.

The Chairman replied affirmatively. In his judgment, because of the Treasury financing now in process it would be desirable to allow the Manager a considerable degree of discretion in making operating decisions. He was proposing simply that the Committee indicate the direction in which it was leaning, leaving the question of feasibility to the Manager.

In reply to a question by Mr. Hayes, Mr. Holmes said he would interpret the Chairman's proposal to call for aiming at a funds rate of about 5-1/2 per cent at the outset of the period and subsequently at a rate in the upper part of a 5-1/2 to 5-3/4 per cent range, if that proved consistent with even-keel considerations.

Mr. Brimmer noted that according to the blue book a Federal funds rate in the 5-1/2 to 6 per cent range was likely to be associated with a three-month Treasury bill rate in a 5-1/2 to 6-1/8 per cent range. He asked whether the Manager would expect the bill rate to fluctuate in a lower range if the upper limit for the funds rate was cut back to 5-3/4 per cent.

Mr. Holmes replied that bill rate fluctuations might encompass the combined ranges shown under alternatives A and B, depending on demand and supply factors. Indeed, the rate might well fall below the 5-3/8 per cent lower limit shown under A; it was only 5.40 per cent today.

Mr. Maisel noted that the alternative A specifications called for seeking a funds rate somewhat above 5-1/2 per cent if M_1 appeared to be expanding faster than the 6 per cent rate projected for August and the 8-1/2 per cent rate projected for September under that alternative. As he saw it, the key question was whether the members would want the Manager to aim at a funds rate above 5-1/2 per cent even if the aggregates were not exceeding the paths shown under alternative A in the blue book.

Chairman Burns asked the members to indicate whether they would prefer to see the aggregates growing at the rates associated in the blue book with alternative A or alternative B.

The poll revealed that the members were equally divided on the question, with some noting that they had no strong preference.

The Chairman then asked the members to indicate their preferences with respect to the target for the Federal funds rate, as between 5-1/2 per cent on the one hand and a 5-1/2 to 5-3/4 per cent range on the other.

The poll revealed that six members preferred each of those alternatives.

Mr. Robertson remarked that it might be best for the Committee to set aside the staff's estimates--he would call them guesses--of the growth rates in the aggregates that were likely to be associated with particular Federal funds rates. The Committee might simply instruct the Manager to maintain an even keel in the money market during the coming period, while taking any feasible actions that would tend to reduce the longer-run growth rates in the aggregates. To his mind that was the sense of the language of B, the alternative he favored.

Mr. Maisel commented that while he also favored the language of B he thought the Committee had to attach specifications to it. In particular, there was the question of whether the

Manager was to seek funds rates above 5-1/2 per cent if the aggregates were not expanding at rates faster than expected.

The Chairman remarked that it might be useful at this point for the Committee to resolve the issue of directive language, apart from specifications. He asked the members to indicate whether they preferred the language of alternative A or B.

Five members expressed a preference for A and seven for B.

Mr. Daane said he thought the Committee's intentions with respect to even-keel considerations would be clearer if the order of the clauses in alternative B was shifted to place the clause reading "taking account of the current Treasury financing and of developments in capital markets" before, rather than after, the statement that "the Committee seeks to achieve more moderate growth in monetary aggregates over the months ahead."

Messrs. Hayes and Brimmer said they also would favor that reordering.

Chairman Burns asked if there were any objections to Mr. Daane's suggestion and none was heard.

Returning to the question of specifications, the Chairman asked for an expression of preferences with respect to the Federal funds rate target as between a level of 5-1/2 per cent and a range of 5-3/8 to 5-3/4 per cent.

Five members indicated that they would prefer the former and seven the latter.

The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft of the first paragraph with the modification that had been agreed upon earlier--the insertion of the word "mainly" before the clause relating to capital outflows--and alternative B for the second paragraph with the reordering of clauses Mr. Daane had suggested. The target range for the Federal funds rate would be 5-3/8 to 5-3/4 per cent. It would be understood that the Manager would have more than the usual amount of discretion in making operating decisions, but that the Committee was inclined to have the funds rate moved towards the upper end of the indicated range if the Manager believed that that action would not do damage to the Treasury's financing.

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

The information reviewed at this meeting suggests that moderate expansion in real output of goods and services is continuing and that unemployment remains substantial. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in both consumer prices and wholesale prices of industrial commodities has stepped up again recently after moderating earlier in the year. In the second quarter inflows of consumer-type time and savings funds at banks and nonbank thrift institutions were large, but below the unusually rapid first-quarter pace. Growth in bank credit and the broadly defined money stock slowed in the second quarter, but the rate of expansion in the narrowly defined money stock increased. In July, according to partial data, it appears that both bank credit and the narrowly defined money stock are growing at rates close to those of the second quarter, but that expansion in broadly defined money is slowing. While interest rates on most types of long-term market securities have changed relatively little on balance in recent weeks, short-term interest rates have risen further. In mid-July Federal Reserve discount rates were increased by one-quarter of a percentage point to 5 per cent. The deficit in the U.S. balance of payments remained extraordinarily large in the second quarter, mainly reflecting capital outflows related to expectations of shifts in foreign exchange rates and the development of a substantial deficit in the merchandise trade balance. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, taking account of the current Treasury financing and of developments in capital markets, the Committee seeks to achieve more moderate growth in monetary aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with those objectives.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, August 24, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida
Deputy Secretary

ATTACHMENT A

July 26, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on July 27, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that moderate expansion in real output of goods and services is continuing and that unemployment remains substantial. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in both consumer prices and wholesale prices of industrial commodities has stepped up again recently after moderating earlier in the year. In the second quarter inflows of consumer-type time and savings funds at banks and nonbank thrift institutions were large, but below the unusually rapid first-quarter pace. Growth in bank credit and the broadly defined money stock slowed in the second quarter, but the rate of expansion in the narrowly defined money stock increased. In July, according to partial data, it appears that both bank credit and the narrowly defined money stock are growing at rates close to those of the second quarter, but that expansion in broadly defined money is slowing. While interest rates on most types of long-term market securities have changed relatively little on balance in recent weeks, short-term interest rates have risen further. In mid-July Federal Reserve discount rates were increased by one-quarter of a percentage point to 5 per cent. The deficit in the U.S. balance of payments remained extraordinarily large in the second quarter, reflecting capital outflows related to expectations of shifts in foreign exchange rates and the development of a substantial deficit in the merchandise trade balance. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of 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 prevailing money market conditions; provided that somewhat firmer conditions shall be sought, taking account of the current Treasury financing and of developments in capital markets, if it appears that the monetary and credit aggregates are significantly exceeding the growth paths expected.

Alternative B

To implement this policy, the Committee seeks to achieve more moderate growth in monetary aggregates over the months ahead, taking account of the current Treasury financing and of developments in capital markets. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with those objectives.