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, September 15, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Heflin
Mr. Hickman
Mr. Maisel
Mr. Robertson
Mr. Sherrill
Mr. Swan

Messrs. Galusha, Kimbrel, Mayo, and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Eastburn, Clay, and Coldwell, Presidents of the Federal Reserve Banks of Philadelphia, Kansas City, and Dallas, respectively

Mr. Holland, Secretary
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Craven, Gramley, Hersey, Hocter, Parthemos, Jones, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account

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

Mr. Coyne, Special Assistant to the Board of Governors
Mr. Wernick, Adviser, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the Secretary, 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. Plant, First Vice President, Federal Reserve Bank of Dallas
Messrs. Eisenmenger, Link, and Taylor, Senior Vice Presidents, Federal Reserve Banks of Boston, New York, and Atlanta, respectively
Messrs. Bodner, Scheld, Doll, and Green, Vice Presidents, Federal Reserve Banks of New York, Chicago, Kansas City, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on August 18, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on August 18, 1970, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period August 18 through September 9, 1970, and a supplemental report covering the period September 10 through 14, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner observed that prices in the private gold markets had moved up about $1 to $36.35 in the period since the previous meeting of the Committee. The rise was a result of seasonally high industrial buying and hoarding demand from traditional Middle East and Far East sources. There had been no evidence of significant speculative influences. No doubt, part of the rapid rise could be accounted for by the competition between London and Zurich for primacy in the gold marketing business.

On the official side, Mr. Bodner continued, there had been in July and August a few significant sales of gold by the U.S. Treasury--the first such sales this year--including sales to Switzerland, the Netherlands, and China--the latter for payment to the International Monetary Fund. In the next couple of weeks the Treasury would be reselling $400 million in gold to the Fund. That amount was one-half of the $800 million sold to the Treasury by the Fund in the 1950's for the purpose of acquiring earning assets. In conjunction with the sale, the Treasury expected to reduce the gold stock by $250 million. At the same time, the Fund would be distributing gold acquired this year--mainly from South Africa--and the Treasury's share of that gold would be about $100 million, with another $30 million to be taken in the form of Special Drawing Rights. Thus, the net gold loss to the United States would be $300 million, reflected in the $250 million reduction in the gold stock and a $50 million decline in the gold holdings of the Exchange Stabilization Fund. The ESF would still have sizable gold holdings.

Mr. Bodner commented that there had been a late summer pickup in activity in the exchange markets, but after a hectic week at the beginning of this month, the markets again had tended to settle down. Money markets on the continent had remained tight, while U.S. banks had further reduced their borrowings from the Euro-market. Consequently, there had continued to be flows of funds into major continental centers. In addition, there had been large flows of funds out of the United Kingdom.

Mr. Bodner indicated that the long slide in the sterling rate, which began last April, had continued through August and early September. Growing uncertainties about the labor situation in the United Kingdom and the absence of any firm indications of the new government's economic policies had resulted in an increasing tendency to sell sterling both spot and forward. That selling, which had occurred primarily in Europe, was reinforced by revived speculation that the British Government might decide to float sterling. There had been heavy pressure at the beginning of this month and, having run out of room to let the rate decline, the Bank of England had had to provide very substantial support. Over the period, the Bank of England's losses were $550 million, the bulk occurring in three days early this month. A good part of that pressure was the result of short sales by banks covering their forward purchases from customers as industrial firms once again began selling forward sterling in large amounts. Consequently, there was a sharp squeeze for sterling balances and a technical rally toward the end of last week that carried the spot rate briefly up to $2.39. Although nothing had changed in the underlying situation, that rally did forestall any further massive selling and, in fact, the market had turned rather quiet. The spot rate was holding reasonably above the floor and the discount on three-month forward sterling had narrowed from about 2-1/2 to 1-1/2 per cent. The release of trade figures yesterday (September 14) showing a very large deficit in August had had only a marginal impact on the market. When one adjusted for the effects of the dock strikes in the United Kingdom by averaging the results of the last two months, the figures showed a trade deficit of about the same order of magnitude as in June. While that implied a current account surplus running at a very much lower level than earlier in the year, there most likely was still a surplus. With the fall months being a seasonally adverse period for sterling in any case, and with British interest rates still not competitive despite some easing in the Euro-market, some rundown in the reserves was to be expected, even in the absence of any new developments. As had been seen, however, speculative episodes could greatly aggravate those pressures and there was little doubt that the System would soon be called upon to provide some financing for the United Kingdom. Despite the improvement in the spot rate in the last few days, the Bank of England had not been able to recoup any of the reserve losses of the past month and so Mr. Bodner anticipated a swap drawing before the end of September and, of course, very much sooner if there was any revival of the selling pressure. Nevertheless, over the somewhat longer term, the outlook was still good that such drawings would be repaid in the winter and spring when sterling was normally stronger.

Mr. Bodner noted that in Germany there also was some increase in activity toward the end of the period as the German money market tightened up once again following the imposition of more restrictive reserve requirements by the German Federal Bank. The mark had stayed very close to the ceiling and during the period the Germans had taken in some $500 million spot and forward. Despite that further addition to Germany's already large reserves, there had not yet been any indication that the German Federal Bank planned to repurchase the gold sold earlier to the U.S. Treasury.

With the exception of the lira, Mr. Bodner observed, the other continental markets generally had been quieter than they were in the first half of August. The improvement in the Italian position, which was evident at the time of the Committee's last meeting, had generally continued since then, although the lira had weakened somewhat from the highest levels it reached and did require some support on two occasions in the week ending September 11. On balance, the Bank of Italy had been able to take in some $214 million since the last meeting. The improvement in the lira situation seemed, however, to be tenuous at best, reflecting some slowdown in the outflow of resident funds coincident with the time of peak seasonal strength for the lira. The trade position was still unsatisfactory, and although the government had brought forth measures to deal with certain aspects of the fiscal crisis, the Italian authorities were a long way from dealing with the fundamental social problems. Consequently, no one, least of all the Italians themselves, thought that the improved atmosphere was likely to last very long. In that respect, it was not insignificant that when the U.S. Treasury had asked the New York Bank to indicate to the Bank of Italy that it would prefer not to renew the $250 million ad hoc credit line extended last spring unless the Italians felt it was really necessary, Governor Carli had responded that he did not regard the current situation as stable and he therefore felt very strongly the need for the Treasury's potential assistance.

After a fairly long period of quiet, Mr. Bodner said, there was a pickup in activity in the Belgian market last week, relating in part to a tightening of money market conditions as a result of a new government bond issue. At the end of the week the Belgians had asked the Federal Reserve to draw another $35 million on the swap line. That drawing, and one for $10 million made at the end of August, brought the Federal Reserve's commitment under the swap facility up to $130 million equivalent. In the case of the Netherlands, there had been no activity since just after the last meeting, with the guilder remaining firm but below the intervention level. On the day after the last meeting of the Committee, the Dutch took in about $60 million and the drawing made to cover that intake brought the System's commitments up to $220 million equivalent. There was a possibility of a further inflow to the Netherlands, particularly if the mark or sterling situations heated up again. Should such inflows result in an exhaustion of the System's swap availability of $300 million, however, the Special Manager was inclined to recommend that the Dutch look to the U.S. Treasury for further cover, rather than to an increase in the System's swap line.

Mr. Bodner added that there were no new developments in the Swiss market and no further inflows to the Swiss central bank. In the case of France, there had been some sizable reserve gains at the beginning of the month, but since then the market had turned very much quieter. That was largely a seasonal phenomenon; with French industry restarting after the holidays and import requirements consequently high, September tended to be an adverse month. The

Canadian dollar market had quieted after an initial flurry of grain business, but the exchange rate had again moved up to the very high level of $0.9850. Following sizable intervention in the first half of August the Bank of Canada had stayed on the sidelines. At the moment, the market tended to be fairly thin and highly volatile with most dealers maintaining short positions in the belief that the rate was unsustainably high.

All in all, Mr. Bodner concluded, the exchange markets seemed to be settling down fairly well after a rather rocky start to the month. There probably would be further flows out of the United Kingdom, and unquestionably Germany and probably one or two other continental countries would add further to their reserves. Nevertheless, the release of the Fund report on exchange flexibility seemed to have helped calm things down and the atmosphere was much better than a couple of weeks ago. At this point there still did not seem to be anything in the offing for which the System did not have adequate facilities.

> By unanimous vote, the System open market transactions in foreign currencies during the period August 18 through September 14, 1970, were approved, ratified, and confirmed.

Mr. Bodner noted that a series of System drawings on the National Bank of Belgium totaling $75 million would reach the end of their first three-month terms between September 30 and October 29, 1970. At this point he did not see much likelihood that the System would be able to repay the drawings and he would recommend Committee authorization to renew them for another three-month period.

> Renewal of the System drawings on the Belgian National Bank maturing between September 30 and October 29, 1970, was noted without objection.

Similarly, Mr. Bodner continued, there would be two System drawings on the Netherlands Bank totaling $75 million maturing October 23 and 27, 1970. In that case also the near-term prospects for repayment were relatively bleak and, although in the longer run he thought the drawings might well prove reversible, he would recommend renewal for another three months; first renewals would be involved in each case.

> Renewal of the two drawings on the Netherlands Bank maturing October 23 and 27, 1970, was noted without objection.

The Chairman observed that Mr. Daane had just returned from meetings in Basle with a most interesting report. He invited Mr. Daane to summarize his impressions from those meetings.

Mr. Daane remarked that the meetings had proved highly unusual in that a surprisingly limited amount of attention was devoted to the United States. The Europeans were preoccupied with their own internal problems and with matters relating to economic and monetary cooperation among themselves. Governor O'Brien had commented on the labor disturbances and serious wage inflation in Great Britain at a time when unemployment was at its highest level since the end of World War II. He observed that it would be exceedingly difficult to resolve those problems without contributing to inflation, and he also indicated in confidence that he thought it would prove necessary to extend the 1968 sterling agreement. A considerable amount of time was devoted to Italy, and Governor Carli had expressed a favorable opinion of the new government's measures to increase taxes and reduce expenditures. The Canadian situation was also discussed at some length. Governor Rasminsky had suggested that it was unlikely that the Canadian dollar would be moved back to a fixed parity in the near future; he cited the rapid rise in the exchange rate, which had been fostered by seasonal strength in the Canadian balance of payments, and concluded that on the basis of past experience the current rate could not be held. In the relatively brief discussion of the United States situation, he (Mr. Daane) had commented on the encouraging balance of trade statistics and his comments had been received with some degree of satisfaction by those present.

The discussion at the dinner meeting of Governors, Mr. Daane continued, had focused on the relationship between wages and productivity and on what a central bank could do--in terms of influencing governmental policy and in terms of its own policy--to try to keep wages in line. There had been no real discussion of the issue of exchange rate flexibility, apparently because it was assumed that there would not be much forward motion on this problem at the upcoming meetings in Brussels and Copenhagen.

Mr. Solomon then presented the following statement on international developments:

The annual meetings of the International Monetary Fund and the World Bank will take place in Copenhagen beginning at the end of this week. And the Ministers and Governors of the Group of Ten will meet in Brussels on Saturday.

As far as the IMF and the Group of Ten are concerned, the principal subject on the agenda will be the Fund report on "The Role of Exchange Rates in the Adjustment of International Payments." As the Committee knows, the Executive Board of the Fund has studied this subject over the past year, with the active participation of the United States, and the report has just been released to the public.

Because there will be much public discussion of this matter over the next couple of weeks, I thought that the Committee might like to have today a brief summary of the Fund report and some indication of its significance.

The Fund report is in two parts: (1) a detailed analysis of the working of the present exchange system, including its advantages and deficiencies, together with a review of various proposals for change in the present system, and (2) a discussion of the policy implications of this analysis.

Following an excellent description of the mechanics of the present exchange system, including the passive role of the dollar, the report discusses the achievements of the system. Among these are (1) the absence of competitive depreciation, which was a major aim of the founding fathers at Bretton Woods; and (2) the maintenance of stable exchange rates and orderly exchange arrangements by a large number of Fund members, which has fostered an enormous expansion of international trade but has also, at times, brought large and destabilizing capital flows.

The major problem or deficiency in the working of the system has been that exchange rate adjustment has often been unduly delayed. Such delays can aggravate domestic problems, while permitting very large external imbalances to build up. At the same time, massive speculative flows may be generated. The result of such undue delays in adjusting exchange rates may be a failure to achieve other objectives, such as domestic stability or the absence of restriction on current transactions.

Regarding proposals for changing the system, the report rejects freely fluctuating rates, substantially wider margins, and an automatic crawling peg. It extols the system of stable exchange rates but emphasizes that this does not mean rigid rates.

The report recognizes the need for more prompt adjustment of exchange rates where fundamental disequilibrium exists. Even under the present interpretation of fundamental disequilibrium, prompter and smaller rate adjustments could be approved by the Fund. But the report leaves for further study proposals that member countries be given a certain degree of leeway to adjust their exchange rates without prior IMF approval.

No consensus was reached on proposals for a slight widening of margins.

A transitional float, such as that adopted by Germany a year ago and by Canada now, is looked upon with sympathy, provided certain safeguards are respected. But the report leaves open whether such a temporary deviation from par value should be legitimized by an amendment to the Fund Articles.

On the basis of this summary, what can be said about the significance of the Fund report? My own interpretation is as follows:

The report will, I believe, strengthen the view that exchange rate adjustment is a respectable instrument of economic policy rather than an act of desperation. For a while during the 1960's the view was prevalent that exchange rates should remain fixed, at least among major industrial countries. The most dramatic manifestation of that view was evident in the many-sided effort to keep the British pound from being devalued. I believe that the fixed exchange rate idea is now rather dead.

A second observation worth making is that the present exercise in international monetary reform is different from the Special Drawing Rights exercise. In the case of the SDR's, a mechanism was developed and it was brought into definitive operation. The present exercise has to do with the behavior of monetary authorities regarding their exchange rates. If such behavior changes, it will become evident only slowly over time. I am inclined to believe that the discussion that has occurred over the past two years will in fact lead to more prompt exchange rate adjustment in the future, upward as well as downward, even if the Fund never formally blesses any of the three techniques discussed in the report.

> Whether or not an amendment to the Articles of Agreement should be sought is an open question. The U.S. position is to keep it open, partly for the purpose of maintaining momentum behind the study of exchange rates and partly because no one is sure that an amendment is needed.
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> In this connection, it is quite possible that par values will be adjusted more readily even under the existing Articles of Agreement but that the problem of preserving some independence for monetary policy in a world of highly mobile capital will lead more and more to support for somewhat wider margins for exchange variation around parities. This would definitely require an amendment.

Chairman Burns said he shared Mr. Solomon's view that the Fund's report contained an excellent description of the foreign exchange system. He added that Mr. Solomon's comments on highly controversial issues could lead to a most interesting discussion but in light of today's heavy agenda he would suggest that Committee members limit their observations.

Mr. Hayes said he did not agree with Mr. Solomon's characterization of the changing attitudes toward fixed exchange rates. He had never sensed the degree of rigidity implied by Mr. Solomon toward changes in exchange rates and indeed he could recall a number of instances during the 1960's when particular changes were regarded as desirable by international monetary authorities. In the case of sterling, efforts to assist the British in maintaining the pound's parity had been related to sterling's exceptional position as a major trading and reserve currency. In sum, he thought there had been some change toward greater flexibility in attitudes toward exchange rates but not a revolution.

Mr. Solomon said he had not meant to imply the change in attitudes toward exchange rates constituted a revolution. He himself did not so regard the change and he would agree that nobody else did.

Mr. Brimmer recalled that in November 1967 he had undertaken the assignment of informing European authorities that the Committee had voted to participate in the loan arrangement to support sterling's parity. There was a good deal of concern at the time that a devaluation of the pound would lead to a cascade of other devaluations. In retrospect he thought the concern was real and that there would be similar concern in a comparable situation today.

Mr. Hayes remarked that there was always concern that a devaluation of sterling would endanger the dollar.

In reply to a question by Mr. Brimmer, Mr. Solomon said he thought the position of the United States toward the IMF report would be to commend it to the attention of the other nations at the approaching meetings in Brussels and Copenhagen and to recommend further study. The issue of exchange rate flexibility was one on which the United States was maintaining a low profile. None of the U.S. officials had revolutionary views on this issue and in any event the major European countries would follow their own counsel in situations where their currencies appeared to be in disequilibrium. The only kind of action that could be taken on this matter would be to amend the Articles of Agreement of the Fund and he thought the United States would not push for such an amendment but would try to keep the whole subject open for the coming year.

Mr. Daane commented that there might well be evolving more flexibility in one part of the international financial system and less in another. He sensed that the world at large was moving toward a system of greater exchange rate flexibility at a time when the Common Market countries were working toward their own system of very limited flexibility. With respect to the Fund report, it was his opinion that it would contribute in due course to a useful change in attitudes as the world's monetary authorities digested it.

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

Mr. Wernick made the following statement concerning economic developments:

> It now appears that real economic activity will show little, if any, real growth this quarter. The impact of the GM strike, even though it only affects the latter part of September, probably will be such as to offset most or all of the rise in real GNP shown in the staff projection for this quarter. There has been a strong pickup in residential construction activity, but most other sectors of the economy have not yet shown signs of renewed strength. Consumer spending has remained relatively sluggish--August retail sales were down

slightly from the July level and only 4 per cent above a year ago, and early September auto sales were weak. Spending for business fixed investment has apparently leveled off and in real terms is now down significantly from earlier peaks, while defense expenditures appear to be declining further.

The lack of any significant upward movement in the economy was evident in key economic series in August. The production index remained essentially unchanged and has now been on a plateau since May. Marginal changes in consumer and materials output continued to be offset by persistent declines in business equipment and defense production over the period.

Nor is there evidence of any strength in the labor market data. Leading indicators in this area--average hours of work in manufacturing and initial claims for unemployment compensation--seemed to be showing some rebound early in the summer but have weakened recently. Adding to the lackluster picture was a further drop in production and nonproduction worker employment in almost all manufacturing industries in August. Although the unemployment rate has remained relatively stable since May, there is some question as to whether this stability has adequately reflected changes in labor availability. The labor force has shown no growth since spring. Younger persons have apparently failed to enter the labor force in the face of weakening demands for workers. Growth in the labor force seems certain to resume soon and given current weak employment prospects, this could bring a further increase in the unemployment rate.

On the labor cost side, the news is somewhat more encouraging. Unit labor cost increases are continuing to moderate. Based on current estimates of output and employment, productivity gains in the private economy are likely to be relatively large again this quarter. In addition, despite continued large wage settlements, there has been a noticeable slowing in the rate of increase in average hourly earnings, reflecting, at least in part, changing demand-supply conditions in the labor market. In manufacturing the slowing in hourly earnings is primarily due to reduced overtime and shifting industry weights. But in the trade and services sectors, particularly, where collective bargaining is less important in wage determination, the growing supply of labor appears to be an important factor limiting the rise in wages. Hopefully, these developments will be reflected in a continued abatement of price pressures.

Turning to the outlook, strikes have introduced new uncertainties as to the timing and extent of a rebound. Most informed guesses are that the auto strike will not be a lengthy shutdown because the differences as to contract terms between the company and the union are less than publicly indicated. A relatively short auto strike would largely affect inventories in the third quarter. An extended strike would check the anticipated fourth-quarter rise in real GNP, but much of the loss of output and income would probably be made up in the first quarter of next year. The longer the strike, of course, the greater the possibility that loss of income could have lasting secondary effects on the over-all level of activity.

Assuming that this will not be a lengthy strike, it seems to me that the staff projection of a slow recovery in economic activity continues to be the most reasonable of a number of possible alternatives. The anticipated recovery depends on a marked expansion in residential construction and a sustained pickup in State and local spending. The recent upsurge in housing starts and the continued large inflow of funds into depository institutions have, therefore, been favorable factors. If relatively large inflows into bank and nonbank intermediaries persist and if financial markets turn gradually easier, housing starts should recover sharply to about a 1.8 million rate by the second quarter of 1971, and residential construction expenditures could be as much as 20 per cent higher than in the current quarter. There could well be resistance to the high cost of housing and relatively high mortgage rates, but if funds become increasingly available, strong underlying demand influences would seem to assure substantial strength in this sector as housing deficiencies are made up.

On the other hand, the prospects for appreciable independent strength in consumer spending have become more uncertain. Added income from increased Social Security payments, tax reductions, and the Federal pay raise, so far, have helped more to sustain than to stimulate consumption, and the initial impact of these payments is now behind us. Aside from these factors, personal income growth has not been large; in real terms total income has been level in recent months while real wage and salary income has edged down further. That consumers remain cautious is again emphasized by the recent Michigan survey, and no near-term change in plans to purchase consumer goods is signaled by the survey findings. On balance, we still think that, with an assist from a lower saving rate, consumer spending will continue to increase at about current rates of growth through the second quarter of next year.

Another important imponderable is the extent of weakness developing in business fixed spending. The recent Commerce-SEC survey of planned plant and equipment expenditures and the NICB survey of manufacturing capital appropriations seem to imply somewhat more optimistic prospects for capital spending than the staff had earlier assumed. The unfavorable factors which are currently affecting capital spending--weak profits, excess capacity, sluggish markets, inadequate liquidity--continue to suggest a decline in spending over the next year. However, the recent survey data do suggest that we are unlikely to see the kind of sharp drop in such spending typical of previous recessions. As a result, we have shaded up our projections and now show a slightly smaller decline in spending for business fixed investment.

Currently, real growth is at a virtual standstill and pressures on prices and unit labor costs appear to be abating somewhat. With slow recovery expected to follow termination of current strikes, further widening in the gap between actual and potential GNP seems probable over the next year. As a consequence, plant capacity utilization is likely to remain well below 80 per cent and unemployment should continue to rise. Indeed, the projected rise in unemployment in the current green book 1/ is probably on the conservative side because labor force growth and productivity increases may well turn out to be larger than we expected, and because of secondary strike impacts.

Under current and prospective conditions, therefore, the risk that the economy will rebound and that excess demands will again rekindle inflationary pressure any time soon, it seems to me, is quite low. The greater risk at present is that the widely heralded upturn in the economy may prove exceedingly weak or nonexistent, which would have rather significant implications for consumer and business expectations. The need is for some further stimulative economic policies. Therefore, I think adoption of alternative B 2/ would help assure sustained recovery in

1/ The report, "Current Economic and Financial 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.

housing activity and help to provide the basis for a more satisfactory expansion in the demands for unused resources over the months ahead.

Mr. Axilrod made the following statement concerning financial developments:

Since the last meeting of the Committee, and the announced modest reserve requirement cut, long-term market interest rates, apart from Treasury coupon issues, have shown little net change and generally remain 30 to 40 basis points above lows of late February and March. Short-term interest rates have generally drifted down since mid-August, however. The drop in bill rates was in the order of 15 to 20 basis points, leaving yields on Treasury bills about 25 to 35 basis points above levels reached at the time of the sharp expectational shift in dealer attitudes in late March. Yields on Federal agency issues and finance company and commercial paper meanwhile declined by around 25 to 30 basis points. The modest narrowing of the yield spread between commercial paper and Treasury bills probably reflects some recovery of investor confidence in the commercial and finance company paper market.

The behavior of long-term interest rates can be explained in a number of ways. First, the volume of corporate issues coming to market was extremely large and the future calendar showed signs of building up; and in the municipal market the volume of new issues after being stable at the advanced rate of about $1.3 billion per month over the first eight months of the year seems to have jumped up to a $1.7 billion per month range as earlier postponed borrowing appears finally to be coming to market. Second, there appears to have been some rekindling of interest in the stock market on the part of large institutional investors. Third, initial expectations about how low the Federal funds and other short-term rates might drop after the reserve requirement cut were disappointed, and this appeared to influence attitudes toward long-term securities.

Finally, the large growth in the outstanding published money supply from July to August was interpreted in a "damned if you do--damned if you don't" fashion by market participants. Either the Federal Reserve would let money growth become what appeared as excessive to some market professionals, in which case inflation would persist and market interest rates remain high. Or the Federal Reserve would tighten the money market, which seemed to be happening in any event, in order to moderate growth in money, in which case market interest rates would remain high. Obviously, both explanations cannot be used simultaneously to explain interest rate movements over the same short time period, but the attitudes of market participants are not necessarily conditioned by logic.

While interest rate developments do not suggest much, if any, easing of credit conditions in long-term credit markets since the last FOMC meeting and only a minor easing in short-term credit markets, interest rates themselves do not tell a complete story. The availability of credit does appear to have eased somewhat further. The sharp buildup in the municipal calendar noted earlier is one bit of evidence in that respect, as it mainly reflects the increased availability of credit from banks. In addition, new residential mortgage commitments probably increased somewhat further in August, following a July new commitment volume at thrift institutions that was the largest in about 18 months. And there was a drop-off in bids in the most recent FNMA auction, perhaps partly reflecting an increased availability of funds from private lenders and investors. As to business loan terms at banks, most banks we have contacted in recent weeks indicate only a very limited easing of lending policies since the reserve requirement action, but one or two large banks do seem to have significantly loosened the fetters on their loan officers and there was a little further give on the prime rate yesterday.

The sustained large net inflow of funds to banks over the past two months has evidently been a factor in this easing of credit conditions. This inflow has been mainly the result of a 30 per cent annual rate of increase in time deposits. Some of these funds were used to repay Euro-dollar and commercial paper borrowings, and others, particularly in July, reflected the recycling of commercial paper borrowing through the banks. In addition, banks were able to increase their liquid asset holdings. In August at large commercial banks the ratio of liquid assets to total liabilities rose to 10.3 per cent, which was 1.4 and .7 percentage points better than in the same months of 1966 and 1969, respectively, but which indicated less liquidity than in 1967 or 1968. A lot of the recent liquidity, moreover, has been purchased through the issuance of quite short-term CD liabilities. If one expected interest rates to rise or Regulation Q ceilings to become a constraint, one would not tend to consider liquid assets purchased through issuance of short-term CD's as representing much liquidity.

The liquid asset position of savings and loan associations, like banks, is improved over 1966 and 1969 but worse than in 1967 and 1968. The rise in the rate of net savings inflows in the second quarter of this year and the unusually rapid rate of growth in July were the principal cause of the liquidity improvement. Our preliminary information suggests a sharp drop-off in net savings inflows at S&L's in August to a pace more like the second quarter and one more consistent with current interest rate relationships. Similarly, at banks net inflows of time deposits other than CD's dropped to a more moderate rate last month.

It would seem to me that the dependence of renewed moderate economic expansion on residential construction and State and local spending--types of outlays highly sensitive to financial conditions--indicates a continued need for an easing of credit conditions. That does not mean continuation of expansion in bank credit at the unusually rapid July-August rate or of thrift institution credit at its exceptional July rate. But a further easing of credit conditions probably does require a lowering of market interest rates in the near future, so as to encourage potential borrowers and to accelerate an easing of institutional lending terms, and also requires continued efforts to facilitate reliquefication of the economy--not only for financial institutions, but also for nonfinancial business corporations whose liquidity position remains quite strained despite sizable debt restructuring so far this year.

This further easing of credit conditions might be accomplished by dropping the Federal funds rate back below 6-1/2 per cent and sustaining it there, which would convey an announcement effect to the market, given attitudes of recent weeks, and would probably encourage or accelerate a renewed decline in other market rates. It is always difficult, of course, to determine how much of an easing in credit conditions should be sought. A reasonable rule of thumb under current economic circumstances would be to ease up to the point where the money supply grows at about a 6 per

> cent annual rate over the fourth quarter, even if this requires a Federal funds rate fluctuating around the 6 per cent discount rate. Such a money growth would help satisfy the greater demands for money that are normally associated with reliquefying the economy and would run little risk of generating excess demands for goods and services in an economic environment with the amount of resource slack that we have now developed.

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 August 18 through September 9, 1970, and a supplemental report covering the period September 10 through 14, 1970. Copies of both reports have been placed in the files of the Committee.

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

> Over the period since the Committee last met most interest rates declined on balance, although a substantial buildup of the corporate calendar resulted in virtually no net change in that sector of the capital market. The Board's changes in Regulation D were a major factor tending to push interest rates lower, as were the quite comfortable conditions that prevailed in the money market early in the period. Later in the period there was some tendency for money market conditions to firm somewhat and for interest rates to back up despite strenuous efforts to supply reserves through open market operations. This tendency stemmed in part from a shift in reserve distribution that adversely affected banks in the money centers, and from what appeared to be a renewed reluctance to make use of the discount window.
>
> There was also some shift in market sentiment, described by Mr. Axilrod, as the published figures for the money supply and the bank credit proxy exhibited very rapid growth in August. A number of market participants expressed the view that the System had eased up too much and was repeating the mistakes of some earlier years.

Some dealers feared that the System would tighten up money market conditions in order to regain control of the growth of the aggregates, and as a result they became a bit restive with their substantial portfolios. Remembering the chill wind of last April, they became very sensitive to even a minor drift upward in the Federal funds rate. The Desk's vigorous efforts to push the rate back down by supplying reserves generously did not do much to calm these fears. I trust that the publication of less exuberant money supply figures in the next week or so--if indeed that is the way the statistics turn out--will dispel some of these worries. In any event a somewhat better atmosphere appeared to prevail at the very end of the period, although it required the provision of well over $1 billion in reserves last Friday to bring it about. A new element was introduced into the picture yesterday when a major Philadelphia bank lowered the prime rate. Although there has been no follow-through by other major banks as yet, market expectations of such a move in the near future have been strengthened.

Short-term interest rates--on CD's, on commercial paper and finance company paper, on short-term tax exempt issues, on bankers' acceptances, and on 3-month Treasury bills--declined by 1/8 to 1/2 percentage point over the period. The commercial paper market appeared to be returning to more normal conditions, with nonbank placers of paper a major beneficiary of the Board's action putting reserve requirements on bank-related paper as banks backed away from issuing short-term paper. In yesterday's regular Treasury bill auction, average rates of 6.31 and 6.49 per cent were established for the new 3- and 6-month Treasury bills, down 22 and 10 basis points respectively from the rates established in the auction just preceding the last meeting of the Committee.

Open market operations over the period involved a liberal provision of reserves, first to foster somewhat more comfortable money market conditions and then to resist the tendency, noted earlier, towards firming that proved quite stubborn at times. Until late last week estimates of money supply growth appeared to be rising above the target path shown in the previous blue book.[1/]

1/ The report, "Monetary Aggregates and Money Market Conditions," prepared for the Committee by the Board's staff.

Until last Friday, the latest available estimates pointed to a third-quarter growth in the money supply in the 5-1/2 to 6 per cent range. Subsequently, the receipt of another week's preliminary data shaved more than a full percentage point from the quarterly growth rate. Moreover, as described in some detail in the blue book, the analysis of new data on cash items in the process of collection led to a further substantial revision in the money supply statistics. While still further revisions may be required, it now appears that money supply grew at a 5-1/2 per cent rate in the first half of the year--compared with the 4 per cent rate reported earlier--but will grow at only a 3-1/2 per cent rate in the current quarter.

These revisions, which will not be made public until later in the year, put us in a rather awkward position since the Committee, in its deliberations, will presumably be using for some time a money supply series that may differ significantly from the series available to the general public. It is obvious that the Desk will need some careful guidance from the Committee on how to handle the new money supply data. With the shift of financing from the commercial paper market to the banking system apparently abating, the credit proxy may now be regaining importance as a significant indicator. It would be helpful to have the Committee's views on whether the behavior of this aggregate measure should carry weight in the conduct of day-to-day open market operations.

There are two additional matters that I would like to mention in passing. Mr. Bodner reported the sale of $400 million in gold by the Treasury to the IMF. In order to pay for the gold the IMF will have to liquidate an equivalent amount of Treasury bills currently held in its gold investment account. We anticipate no problem in effecting this transaction, but it would be useful if the System were in a position to acquire some of these bills directly from the IMF so as to avoid the sale of a large amount of longer-maturity bills in the market. The Treasury's intention to demonetize $250 million of gold in connection with this transaction will be most helpful in this respect since that will absorb an equivalent amount of reserves.

Finally, as you know, the Treasury will have to raise a substantial amount of new money in the last quarter of the year. While current projections indicate that funds will not be needed until late October, the Treasury may decide to borrow earlier in the month in order to avoid a conflict with the November refunding--the terms of which will be in the process of being set at the time of the next Committee meeting. Some even keel considerations--depending on the form the financing takes--may therefore be involved before the Committee meets again, but there is probably no need to make specific reference to this possibility in the directive.

In response to questions by Chairman Burns, Mr. Holmes indicated that the revisions in the money supply data were still quite preliminary and Mr. Axilrod noted that final data would not be ready for publication for another few weeks.

Chairman Burns observed that the current status of the money supply statistics put the Committee in an uncomfortable position. He suggested that the preliminary revisions in the data be kept strictly confidential and Committee members indicated their agreement with that suggestion.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 18 through September 14, 1970, were approved, ratified, and confirmed.

The Chairman then called for a general discussion of the economic and financial situation and outlook, including any questions the members might wish to address to the staff.

Mr. Daane said he had a question regarding the staff's revision of its projection of plant and equipment expenditures. From Mr. Wernick's comments, he gathered that the staff had revised its projection in an upward direction, but he understood from reading European newspapers that the August Commerce-SEC survey indicated businessmen had scaled down their capital spending plans.

Mr. Wernick observed that the staff had interpreted the August survey as suggesting that its own previous projection might have been slightly too pessimistic. While the latest survey results indicated a reduction in capital spending plans compared with earlier surveys, the increase businessmen were still planning in their capital outlays over the balance of the year was more than the staff had anticipated. Therefore, the staff projection, while continuing to call for a decline over the second half, had been revised to show a slightly smaller decline than earlier.

Mr. Hickman remarked that some of his directors had reported a marginal pickup in new orders, including orders for machine tools, and they expected the improvement to continue, provided that overall spending strengthened as they anticipated.

Mr. Wernick said that the recent data for the nation seemed to indicate slightly more strength in new orders for machinery and equipment, and other data suggested that capital appropriations had leveled out following earlier declines.

Mr. Brimmer noted that the Manager had requested Committee guidance on whether the bank credit proxy should be given renewed emphasis in the conduct of monetary policy. He wondered if the staff had considered this problem.

Mr. Axilrod replied that in his judgment the financial system was probably somewhat beyond the point where the initial adjustments to the Board's Regulation Q action and the problems of the commercial paper market were important factors in producing large inflows of time deposits and the related bulge in bank credit. Those adjustments, which had been somewhat larger than might have been expected, could be viewed as a sort of stock adjustment that in his view seemed to be largely completed. He would therefore expect more normal flows of funds through the banking system in the months ahead, and indeed the staff's projection of more moderate bank credit expansion in the fourth quarter reflected such an expectation. Accordingly, he would conclude that the Committee could view the bank credit proxy in its more normal relationship to other monetary variables, making it easier to reintroduce it as an operating variable.

In reply to further questions by members of the Committee, Mr. Axilrod said he had never been able to resolve in his own mind what specific bank credit flows were desirable in a given situation because of the difficulty of distinguishing the aggregate economic effect of credit obtained from banks as opposed to credit obtained from other sources. Moreover, it had to be recognized that interest rate relationships affected the distribution of credit flows between banks and others. He therefore tended not to attach too much weight to the bank credit proxy as a policy variable and preferred instead to put more emphasis on the money supply, which displayed much less interest elasticity. For those who preferred to retain bank credit as a major policy variable, however, his technical assessment was that the bulge in bank credit in response to the recent suspension of Regulation Q ceilings in certain maturity areas was largely an accomplished fact and they could look to more normal bank credit flows in the period ahead.

Mr. Hickman said he thought the way to evaluate bank credit was through the flow of funds data. Unfortunately, those data were available only after a considerable time lag. He thought the staff should undertake research on short-term shifts of funds between banks and the securities markets so as to develop improved methods for making current estimates of total credit flows.

Chairman Burns said he thought Mr. Hickman's suggestion was a good one and that the staff should initiate such research.

Mr. Brimmer indicated that Mr. Wernick's assessment of the impact of the automobile strike and a possible railroad strike was not clear to him. If the automobile strike were to last only a few weeks, which Mr. Wernick seemed to think was likely, the impact would presumably be transitory and would involve only a shift of national income from the third to the fourth quarters. He wondered whether Mr. Wernick's preference for alternative B was based upon his view of the potential effects of the strike.

Mr. Wernick replied that the staff was assuming the automobile strike would be of short duration and that its impact would be transitory. If the strike were over by mid-October, the GNP statistics for the third quarter might be reduced by $2 billion or $3 billion, with little impact in the fourth quarter. The short-term effect on some other statistics, such as the production index and new orders, might be more pronounced, however. The strike could have some influence on expectations, but the staff did not feel any change in its longer-range projections was presently required. If the strike did last longer than the staff was assuming, his own guess would be that a substantial catch-up boost in inventory accumulation and in spending for automobiles would occur in the first quarter of 1971.

With respect to his recommendation of policy alternative B, Mr. Wernick continued, the underlying weakness in the economy reflected by recent lackluster economic statistics was the important consideration in his choice, particularly since he did not think economic activity was likely to improve in the near future without additional stimulus even if strike-related developments were excluded from the outlook.

Chairman Burns recalled that while serving on the Council of Economic Advisers in 1956 he had conducted a study of the impact on the economy of major strikes lasting 4 weeks or longer. The study had indicated that, although the impact on directly affected industries was substantial, the effects on the over-all economy were very difficult to identify unless one were aware of the precise timing of the strikes.

Mr. Heflin inquired whether the staff intended to revise its GNP projections upward in light of the recent revisions in the money supply statistics.

Mr. Axilrod commented that the revision for the first three quarters of the year taken together--as opposed to the revisions for individual quarters--would not be substantial. The currently estimated rate of growth for the first 9 months was about 4-3/4 per cent on the basis of the revised data. The corrected data reflected upward revisions in the first and second quarters which were partly offset by a downward revision in the current quarter. In his judgment, a difference of only 1/2 percentage point in the two growth rates for the 9-month period was well within the margin of likely statistical error and did not of itself call for a review of the staff's GNP projections.

Mr. Maisel observed that member banks had been engaging in a considerable amount of extra borrowing from the discount window in preference to obtaining day-to-day financing in the Federal funds market. He asked whether the repayment of such borrowing by banks that became subject to administrative pressure from discount officers would tend to alter the normal relationship between borrowed reserves and the Federal funds rate.

Mr. Holmes remarked that a number of banks already appeared to have reduced their special borrowing from the discount window in recent weeks, but the Federal funds rate had remained under upward pressure in part because those banks seemed to have increased their reliance on the Federal funds market. Thus, a lower over-all level of member bank borrowing had been associated with a higher Federal funds rate than might otherwise have been expected. An example of the tendency for the Federal funds rate to remain relatively high had been observed on Friday (September 11) when it had stayed above 6-1/2 per cent despite System reserve supplying operations of more than $1 billion and member bank borrowings of only $475 million.

Mr. Holmes added that he did not think the recent relationship between bank borrowings and the Federal funds rate was likely to persist.

Mr. Brimmer noted that while so-called special or conduit lending related to the difficulties in the commercial paper market had declined substantially, there had occurred some offsetting increase in member bank borrowings connected with individual problems of bank management.

In response to another question by Mr. Maisel, Mr. Holmes said he was not sure what impact the General Motors strike would have on financial markets. If the strike continued for some time, there would, of course, be a reduction in the financing requirements of the General Motors Acceptance Corporation.

Mr. Maisel commented that the current slowdown in economic activity had not been accompanied by any major change in inventory investment. Indeed, the rate of inventory accumulation had declined only in the first quarter of 1970 and had subsequently turned up again. The recent experience was in contrast to that in other postwar recessions when actual declines in business inventories had been recorded. From the staff's projections, he gathered that a traditional inventory correction was not expected.

Chairman Burns observed that, while no actual decline in business inventories had occurred, the rate of inventory accumulation had moderated significantly in his view, given the modest dimensions of the current recession or mini-recession.

Mr. Wernick noted that the staff projections for investment and consumption suggested that there would be some pickup in the rate of inventory accumulation. The staff did not foresee a sharp upturn, however, and indeed the recent evidence suggested that some involuntary accumulation was probably still taking place.

Chairman Burns said that a recent survey of sales and inventories indicated that a significant number of manufacturers regarded their inventories as being on the high side. That was especially true in the durable goods industries.

Mr. Maisel said he had two questions regarding the staff's housing projection. He understood that reports from the field now put more stress on the high level of mortgage rates than on the availability of funds as a depressant on the housing market. Demand for mortgage funds apparently was being curtailed because people expected the current high mortgage rates to decline and therefore hesitated to lock themselves into high-cost mortgages. Another factor in the housing picture was the expansion in sales of mobile homes, which implied that the backlog of demand for conventional homes might be more moderate than some observers believed. He wondered what weight the staff was attaching to those developments in its projection of housing starts.

Mr. Wernick replied that the staff was still placing primary emphasis on the prospective availability of financing in its projection of housing starts. Given the improved outlook, he did not think it inconceivable that starts would rise to a 1.8 million annual rate by mid-1971. That level of starts would probably have a restraining impact on the sale of mobile homes.

Mr. Axilrod added that, while the staff projection continued to focus on the availability of mortgage funds, it also assumed that some downward adjustment in interest rates would occur.

Mr. Francis commented with reference to the economic situation that the over-all course of Federal Reserve policy seemed to him to have been about right in the last 20 months. The rates of monetary expansion in 1969 and so far in 1970 appeared, on the whole, to have been appropriate. The relatively slow 1.6 per cent yearly rate of increase in money from January 1969 to February 1970 was desirable following the rapid 7 per cent rate of the preceding two years. The subsequent growth of total spending at a 4 per cent annual rate from the third quarter of 1969 to the second quarter of 1970 also appeared to have been appropriate.

Mr. Francis added that the Committee had reinstituted a policy of monetary expansion in early 1970. He thought it would be desirable if, as projected, money grew at a more moderate rate during the third quarter, given that expansion of the money supply in the second quarter had been at a rate of around 6 per cent. He had seen no persuasive evidence that the Committee had erred on the side of inadequate expansion, though a steadier rate of expansion might have been preferable.

Most recently, Mr. Francis continued, monetary actions regardless of how they were measured had been very expansive. Since June Federal Reserve credit had risen at a 9 per cent annual rate, total member bank reserves at a 16 per cent rate, the monetary base at a 9 per cent rate, money corrected for known biases at a 7 per cent rate, money plus time deposits at a 20 per cent rate, and the bank credit proxy at a 26 per cent rate. Commercial paper rates had declined from about 8-1/4 per cent at the end of June to 7-1/2 per cent currently. Rates on Federal funds averaged about 7-1/2 per cent in June and about 6-5/8 per cent in the last three weeks. Yields on seasoned highest-grade corporate bonds had declined from about 8-5/8 per cent at the end of June to 8-1/8 per cent currently. Monetary and credit developments over such a short period had little economic impact, but in conducting operations in the near future, he thought care should be exercised to avoid taking off into a protracted period of immoderate monetary expansion.

Mr. Mayo noted that the staff was assuming the automobile strike would be of short duration and that its impact on the economy would be transitory and offset later. The people contacted by the Chicago Reserve Bank were much less optimistic, however, and he himself would not be surprised if the strike were to last, say, eight to ten weeks. Assuming a strike of that duration, he wondered whether the staff would still expect its effects to be only transitory or whether some net loss in over-all production would be anticipated. Further, would the staff be recommending a different monetary policy--one more liberal than alternative B--if they were looking ahead to a more prolonged strike?

Mr. Wernick replied that, given the current demand situation in the economy, a longer automobile strike might result in some net loss in over-all activity. The situation today was certainly weaker than at the time of the Ford strike in 1967 when demand in other sectors of the economy readily absorbed any slack resulting from the strike and when in any event the number of idled workers was much smaller. On the other hand, he did not want to discount completely the possibility of a strong rebound in automobile production and consumption once the strike was over.

In reply to Mr. Mayo's question concerning the staff's policy recommendation, Mr. Axilrod commented that a prolonged strike would tilt the odds toward less output in the fourth quarter than the staff was projecting and would, of course, lessen the risks inherent in the adoption of an easier policy. However, too substantial a move in an easing direction could raise problems of its own if underlying demand conditions were strong when General Motors resumed full-scale operations after a strike settlement. On balance, he would still regard the policy associated with alternative B as appropriate for now even on the assumption of a more extended strike.

Mr. Coldwell said he had just returned from a trip to Europe and had found the domestic economic situation about unchanged over the interval since the last Committee meeting. Over-all economic activity remained essentially flat; the money supply data continued to fluctuate widely; and substantial wage-cost pressures persisted. A point of particular interest to him in his conversations with European central bankers had been their comments about their fight with the same problem of rapidly rising wages.

As he viewed the outlook for the rest of the year, Mr. Coldwell added, the economy as a whole was likely to continue relatively flat, despite a reduction in business investment and business efforts to improve liquidity positions. The economy would still be experiencing the worst of two worlds, namely, cost-push inflation and high unemployment. In judging the proper course for monetary policy, he thought the inflationary wage-cost situation remained the primary problem, and although he did not foresee an absolute decline in economic activity, he felt an increasing short-fall of actual production below the economy's potential might well occur.

Mr. Hickman said he agreed with the staff assessment that the economy was in a phase of moderate recovery, although he thought the August data gave rise to some uncertainties. He was encouraged by several favorable trends that had emerged, especially in manufacturers' orders, prices, productivity, and residential construction. On the other hand, the recovery in aggregate activity would be tempered by continued weakness in capital spending and defense outlays. The economy could lose ground, which might not be made up, if the automobile strike were prolonged, but he thought a strike lasting 4 or 5 weeks would have only transitory effects, although some of the interim economic statistics would make uncomfortable reading. If the strike were of relatively long duration, he wondered whether a more liberal monetary policy designed to offset its immediate impact might not run an undue risk of contributing to a resurgence of inflation later. Mr. Axilrod had already commented on this point and might wish to amplify upon his remarks. With respect to the outlook for housing, he was inclined to question Mr. Axilrod's view that a decline in market interest rates would probably be necessary to stimulate an appropriate level of starts. In his estimation, the availability of housing funds was more dependent upon the relationship between interest rates paid by savings institutions and market interest rates, and he thought the latter might well have declined enough already to foster an adequate flow of funds to the savings intermediaries.

Mr. Axilrod said that in his view a protracted automobile strike would make it difficult to achieve a 6 per cent rate of growth in money--and perhaps even a 5 per cent rate--in the fourth quarter unless interest rates were eased, because the strike would be associated with reduced transactions demands for cash. A lengthy strike and associated weakening of economic activity would tend to buttress the argument for aiming at a 6 per cent rate of money growth, although that argument depended fundamentally on an assessment of the economic outlook apart from the strike. On the other hand, he recognized the opposite risk of an inflationary rebound in economic activity later if interest rates were allowed to ease unduly. On balance, though, he came out in favor of the policy targets associated with alternative B. With regard to Mr. Hickman's point about housing, he thought the level of interest rates would have some effect on the demand for housing, and even with an improved availability of funds he believed some reduction in longer-term interest rates would be needed to achieve the 1-3/4 million annual rate of starts projected by the staff for the second quarter of 1971.

Mr. Hickman observed that mortgage rates were typically slow to respond to an easing in market rates, but he thought mortgage rates would decline provided the System did not permit market rates to rise from current levels. Accordingly, he saw no need at this juncture for a monetary policy designed to lower market interest rates further.

Mr. Hayes observed that the economy seemed on balance to be somewhat stronger than at the time of the Committee's last meeting, and he noted in particular the evidence of an upturn in housing starts and in new orders. However, he expected the recovery in economic activity to be gradual. The sharp deterioration in labor market conditions seemed to have halted, but the unemployment rate was edging up further and would probably continue to do so. His reading of the recent Commerce-SEC survey of plant and equipment spending plans was that the cutbacks would be relatively small, given the generally bullish long-term outlook. Admittedly, the evidence of an upturn was still quite tentative and was made the more so by the automobile strike and a possible railroad strike. Indications that the rate of inflation might at last be slowing were also tentative. On the wage front pressures remained intense. Many recent Government announcements of progress in the fight against inflation seemed to make the tacit assumption that the cost-push element need not be of concern now that aggregate demand was under reasonable control. His own feeling, however, was that there was still a very significant risk of a new resurgence of inflation, in view of the underlying cost pressures, unless the recovery in demand was held to a very moderate pace.

On the international side, Mr. Hayes wanted to stress again, especially on the eve of the meetings in Copenhagen, the need to give considerable weight to the dollar's international position in determining monetary policy. With large deficits continuing to accumulate in the United States payments balance, both on the liquidity and the official transactions bases, it remained vitally important to protect and nurture the emerging improvement in the U.S. trade surplus and that of course meant trying hard to check the current rate of inflation. He also noted that the accumulation of dollars abroad and the prospects for the next twelve months could be quite disturbing, particularly with respect to the further development of Special Drawing Rights in the international payments mechanism. The agreement to issue a certain amount of SDR's had been based on the assumption that the U.S. balance of payments would be brought under control. That had not happened and the balance of payments therefore remained an important consideration in System policy.

Mr. Galusha remarked that he had interpreted the recent Michigan Survey of consumer buying intentions in a less negative light than had the staff. He was impressed by the fact that the index of consumer sentiment had risen for the first time after five quarterly declines, although to be sure the rise was small and was not qualified as being quite statistically significant. However, a parallel survey to which he had access had come up with somewhat more bullish results.

With regard to the unemployment situation, Mr. Galusha continued, the Ninth District was feeling the impact of cost-cutting efforts on the part of major corporations. For example, one firm in the heating and air conditioning field had cut some 400 people from its work force even though its sales had been holding up. Traditionally, there were two ways to increase profits, namely to expand markets or to cut costs, and the present emphasis was on the latter. Moreover, he did not think such efforts were at an end. The staff projection suggested that the unemployment rate would rise to 5.6 per cent in the second quarter of 1971. But if aggressive cost cutting were to continue, the rate could rise more. Even a 5.6 per cent rate, however, he regarded as unacceptable for the United States.

Mr. Galusha added that he sensed a good deal of disappointment over the performance of the money supply. He himself was not concerned all that much, and indeed he thought the Committee should avoid giving the appearance of trying to regulate closely the rate of growth in money. Of more importance were the Committee's ultimate objectives and in that respect he felt the performance had been commendable even though inflation and unemployment were proving to be stubborn problems.

Mr. Kimbrel commented that he was inclined to believe that growth in the near term would be at least as hesitant as that projected by the Board's staff. On the surface, that view might not seem entirely consistent with conditions in the Sixth District where performance had been somewhat better than the national statistical performance in respect to employment, unemployment, payrolls, and industrial production. The District's figures, however, were strongly influenced by continued expansion in Florida that more than offset weaker conditions in other parts of the District.

The Board's staff, Mr. Kimbrel continued, evidently counted on higher consumer spending and on rising residential construction to bring about the modest expansion. In the Sixth District, although construction seemed to be tapering off, the picture did not appear to be getting significantly bleaker. Residential construction might have been aided by inflows into savings and loan associations and conceivably could be helped further by lower mortgage interest rates.

His curiosity was aroused, Mr. Kimbrel said, by current reactions of business and consumers. Statistics on corporate profits were recently being revised upward, but plans for business investment were being revised downward. The question arose as to whether that reflected a lack of confidence. Were businessmen and consumers anticipating lower interest rates and accordingly delaying expenditures? A widespread action based on this belief could deepen the mini-recession. Nevertheless, it was his opinion that such a development could contribute to a lessening of inflationary pressures, an outcome he would term desirable.

Mr. Eastburn observed that, in addition to the possible duration and economic impact of the automobile strike, there was also a question about the settlement terms. A generous settlement could, he suggested, have an adverse impact on expectations and more generally on the fight against inflation. If, in addition, the money stock were permitted to grow more rapidly and a substantial decline occurred in interest rates, inflationary expectations would be stimulated seriously further.

Mr. Wernick said he thought the automobile wage settlement would be considerably less than construction and trucking industry pay raises this year, possibly on the order of 9 to 9-1/2 per cent for each year of the wage contract. He expected the settlement to be quite high in the first year, but the raises for the second and third years would probably be considerably lower, particularly if the union were to accept GM's proposals. If a cost of living clause was included as the union was demanding and the rate of price rises diminished, the wage cost increases would also be more moderate after the first year.

Chairman Burns indicated that in his view Mr. Wernick might be underestimating the eventual wage settlement.

The Chairman added that another matter of concern to him was the fate of the Penn Central railroad which was headquartered in Mr. Eastburn's District. The insolvent railroad was experiencing a severe shortage of cash that threatened it with a complete shutdown, and the prospects of raising additional cash, whether from Government or private sources, were poor. This information, of course, had to be held in strictest confidence.

Mr. Morris remarked that he had found the economic statistics of the past month quite disappointing. He had expected to see some signs that the economy was finally turning up, but the tone of the statistics had remained sluggish and suggested a prolonged bottoming-out of the economy. He was particularly disappointed that the improvement in the leading indicators evident in July had not carried through. In his view the recent evidence supported Mr. Wernick's view that the risk of an inadequate rate of economic growth substantially exceeded the risk of an inflationary expansion of economic activity. Those relative risks, he thought, needed to be given policy consideration.

Mr. Hickman commented on the adjustments in the money supply statistics, as discussed in the blue book, and observed that the downward adjustment for the third quarter followed upward adjustments in the first half that were more than offsetting. In his view, therefore, the downward adjustment in the third quarter was not an argument that a faster rate of growth should now be fostered.

Mr. Maisel suggested that the real implication of the adjustments was that the impact on economic activity of a given change in the money supply was less than previously assumed, allowing for the lagged behavior implied in this relationship.

Mr. Sherrill commented that the recovery in economic activity, if in fact it was under way, was still very fragile. The sources of strength were expected to be increasing outlays on housing, State and local government expenditures, and possibly consumer spending. In one respect, this outlook involved a self-limiting feature in that a large volume of savings by consumers would be needed to finance the expansion in housing. Moreover, the current and prospective profits picture offered no encouragement that capital spending by the business sector would be a source of sustaining strength. All in all, he could not see any convincing evidence of a strong recovery.

Mr. Sherrill added that expectations were likely to become an important factor in determining the course of the economy. They would be affected by the automobile strike and he gathered that prospects for a settlement were not viewed as optimistically by the general public as by the staff. If in this environment the economic recovery seemed to be faltering, an adverse turn in expectations might well precipitate a reversal. In sum, he concluded that the Committee would be running a serious risk if it did not pursue a stimulative policy.

Mr. Daane said he was in sympathy with Mr. Sherrill's views regarding the current state of the economy. Numerous uncertainties, including the stock market, were affecting the current business situation, which he agreed was far from ebullient.

Chairman Burns commented that the economy could be characterized as having moved sideways over the past four months. Industrial production had displayed a horizontal trend in that period and the same could be said of the physical volume of construction, both residential and nonresidential. Whatever small increase had occurred in real GNP was traceable to the service industries, for which the statistical information was scant and subject to estimating errors. Apart from the level of output, another dimension of the real economy was the rate of resource use. Employment had continued to decline and unemployment to rise, although both at slower rates. There was, however, a latent increase in unemployment, not reflected in its recorded rate, as many young people discouraged by the unemployment situation had failed to enter the labor force.

The Chairman added that there was evidence of a retardation in the rate of price advances. The wholesale price index had risen at an annual rate of 4.2 per cent in the second half of 1969, but the rate of increase had declined to 2-1/2 per cent in the first half of 1970, and for July and August combined the rate was also 2-1/2 per cent. The rise in the consumer price index was similarly showing signs of abatement. The corporate profits picture, on the other hand, was disturbing. The rate of profits in industry had been sinking since 1965 and had now reached a postwar low.

Chairman Burns concluded that the available evidence pertaining to a possible recovery in economic activity was still quite mixed. As was typical in a period when the economy was moving sideways, various sectors of the economy were displaying divergent trends. One inevitable consequence was an increased division of views regarding the prospects for the economy and the appropriate course for monetary policy.

The Chairman then called for the go-around of comments and views on monetary policy and the directive.

Mr. Hayes observed that in his view the System had moved quite vigorously in the last few months to encourage growth in the monetary and credit aggregates. Bank credit, in particular, had grown very rapidly, and only part of the accelerated expansion could be attributed to difficulties in the commercial paper market. The Committee should, he believed, be on the alert to check any continuance in the coming months of such rapid credit growth. A substantially lower rate of growth seemed a necessary precaution against a repetition of the 1968 experience. To that end, he believed there should be increased stress on bank credit in the directive.

With respect to the money supply, Mr. Hayes continued, the "guerrilla draft" and other distortions had certainly changed the picture in a major way. Thus, the money supply growth rate in the first half of the year appeared to have been a sizable 5-1/2 per cent instead of the previously estimated 4 per cent. Further revisions would undoubtedly take place. Indeed, those developments had been so discouraging that a case could be made for giving up on the effort to formulate policy in terms of growth rates in monetary aggregates. He preferred, however, to continue with that effort, looking forward to a time when the statistics would again be in more workable order; and he continued to feel that a target of moderate growth in both money and bank credit was appropriate.

As far as the directive was concerned, Mr. Hayes found the structure of both alternatives A and B in the second paragraph to be entirely too complicated. He thought there were too many subsidiary objectives--which might mean different things to different people--and very little sense of priority among them. He was quite concerned that both alternatives called for an easing of conditions in the credit markets. There had been, on balance, a significant decline in most short-term interest rates, and despite some backup around the Labor Day weekend, those rates again seemed to be pretty well on track. He was not convinced that a further move towards easier credit market conditions would be required in order to achieve moderate rates of growth in the monetary and credit aggregates in the fourth quarter.

Consequently, Mr. Hayes said, he would suggest an alternative directive, distributed as alternative C, which read as follows: "To implement this policy, the Committee seeks to promote moderate growth in the money supply and bank credit over the months ahead. Unless there are substantial deviations from these objectives, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining the more comfortable bank reserve and money market conditions that emerged after the last meeting of the Committee."

Mr. Hayes indicated that he would interpret moderate growth in the aggregates as a fourth-quarter growth rate of about 5 per cent for the money supply and about 10 per cent for bank credit; those were the rates of growth associated with alternative A in the blue book. But given the strength of the money supply figures over the first eight months of the year, he would not be concerned if its growth rate were to fall short of that target. On the other hand, he would be concerned if the rate of bank credit growth went much above 10 per cent.

Mr. Hayes added that he would hope to avoid not only any overt move toward greater ease, such as a discount rate cut or a removal of ceiling rates on longer-term CD's, but also any appreciable change in money market conditions from those prevailing shortly after the Committee's last meeting. Specifically, he would hope to see the Federal funds rate fluctuating mostly in a 6-1/8 per cent to 6-1/2 per cent range, member bank borrowing of $500 million to $700 million, and net borrowed reserves of around $400 million to $500 million or a little more. He would not, of course, be opposed to allowing the usual swings in money market conditions.

Mr. Francis said it was now estimated that the annual rate of increase in total spending from the first to third quarters of this year had been about 5.5 per cent. That rate of growth had provided some downward pressure on prices while avoiding large cutbacks in real product, and he saw no reason to strive for either a higher or a lower rate during the next year. The St. Louis Bank estimated that a 5.5 per cent rate of increase in total spending during the current fiscal year would be fostered by a growth rate of about 5 per cent in the money stock, given the current Federal budget prospects for the period. According to those estimates, money growth at a rate significantly more than 5 per cent would mean greater growth in real product, but with detrimental price effects. Growth of money at significantly less than a 5 per cent rate would gain more rapid deceleration of price increases, but that might not be worth the cost in terms of real product and employment. He therefore supported alternative A of the draft directives. At the moment he saw no real reason to have much confidence in the credit proxy as an objective of policy.

Mr. Francis added that studies conducted at the St. Louis Bank indicated that with a 5.5 per cent annual rate of growth in nominal GNP, inflation would gradually be reduced, interest rates would move lower, and the growth rate of real output would increase. Although unemployment would probably continue to rise for a period, the rate probably would not rise as high as in past periods when restraints were imposed against inflationary pressures.

Mr. Kimbrel said he doubted that this was the time to make an overt change in monetary policy. Although projections about the future state of the economy differed as to the degree and speed of recovery, a weakening economy was not projected. To try to speed the recovery by a further move toward ease would risk bringing to a halt the process that was dampening inflationary pressures. Moreover, a policy of greater ease carried with it the danger of heightening the expectations of continuing moves toward ease and intensified inflation. He concluded that the objectives contemplated by alternative A of the draft directives were consistent with his views.

Mr. Eastburn inquired whether his understanding of alternative A was correct, namely that it would be necessary to have some further easing of money market conditions to achieve a 5 per cent growth rate in the money stock.

Mr. Axilrod replied that the blue book specified a Federal funds rate in the range of 6-1/8 to 6-1/2 per cent as consistent with a 5 per cent growth rate in money over the fourth quarter. Such a range would imply an average rate somewhat below the typical rates prevailing in recent weeks, but some overlapping of the respective ranges would be involved. Other money market conditions associated with alternative A included member bank borrowings averaging around $500 million and net borrowed reserves around $350 million. Those conditions would be a shade easier than those that had prevailed in recent weeks.

Mr. Holmes added that a 6-1/8 to 6-1/2 per cent Federal funds rate range would describe the market in the period immediately following the last meeting. While the Federal funds rate had risen later in the period despite sizable reserve-supplying operations by the Desk, he thought the specifications for alternative A were the same as those which had been sought in the interval since the last meeting.

Mr. Eastburn said his choice for the directive would be either alternative A or alternative C, but it was not clear to him whether alternative C was deemed consistent with a 5 per cent rate of growth in money.

Mr. Axilrod replied that in his view such an outcome seemed somewhat less probable under alternative C than under A.

Mr. Hayes indicated that he thought alternative C would be consistent with a 5 per cent rate of growth in money over the fourth quarter. Unlike alternative A, alternative C did not call for some easing of conditions in credit markets, but for maintaining the more comfortable money market conditions that emerged in the week following the last meeting. Such conditions would in turn be somewhat easier than those which developed around the Labor Day weekend. Mr. Hayes added in response to further questions that an additional purpose in proposing alternative C was to eliminate the subsidiary clauses which presently surrounded the reference to bank credit in alternative A. In his view those clauses did not provide a clear-cut instruction to the Manager.

Mr. Eastburn observed that the differences between alternatives A and C seemed quite small, but on balance he would prefer alternative A. Although it was not a policy question immediately at issue, he wanted to add a word about the discount rate. If short-term interest rates declined, as he believed they would, the possibility of a reduction in the discount rate would receive increasing attention in the market, but he thought the System should proceed very cautiously before deciding on a change. The discount rate had been well below market rates for a considerable period, and as developments brought it into closer alignment with those rates, it would become a more effective instrument of monetary policy. In the latter connection he noted that there had been renewed discussion of the proposed new discount mechanism, which provided for a more flexible use of the discount rate; he hoped consideration would be given to implementing that mechanism.

Mr. Hickman commented that, although the evidence was not clear-cut, the economy seemed to be in a period of modest growth and on the whole the Committee was achieving its objectives. The statistics for the next few months were likely to be somewhat discouraging, but he thought monetary policy could do little to improve them. Once the automobile strike was settled, renewed indications of progress should become evident. In his view, a 5 per cent growth target for the money supply in the fourth quarter, and a target of roughly twice that growth rate for bank credit, should be ample to meet demands for liquidity and to support moderate economic expansion without aborting the recent moderation in price increases. More rapid growth in bank credit would, he thought, contribute to inflationary pressures in the economy, and he would therefore give increased attention to that aggregate in the implementation of policy.

Turning to the directive, Mr. Hickman noted that he did not have a strong preference for any particular language, but he favored the money market specifications associated with alternative A in the blue book, preferably the mid-points of the indicated ranges. He thought that money market conditions at the lower end of those ranges might bring the current discount rate into question and he agreed with Mr. Eastburn that a change in that rate would be premature. On balance, he was inclined to vote for alternative C, but he could also vote for alternative A. If the latter alternative were adopted, however, he thought it should be made clear on what basis "some easing in credit markets" was to be measured.

Mr. Sherrill commented that his policy preference would be to focus on the short interval between now and the next meeting of the Committee. He had an uncomfortable feeling about the reliability of the money supply statistics and in any event he thought the automobile strike was likely to frustrate efforts to achieve a particular money supply target in the coming period. Accordingly, he would concentrate primarily on interest rates, which in the short run would probably have the most important influence on expectations. His preference would be to foster a small decline in rates from current levels--perhaps to about 5-3/4 per cent for the 3-month bill rate and around 6 per cent for the Federal funds rate. He would, of course, be opposed to an increase in those rates. The level of member bank borrowings and the rate of growth in the bank credit proxy would not be of particular concern to him in a period when banks were still re-positioning themselves as intermediaries and when it was still very difficult to assess their interim strategies. In sum, alternative B of the draft directives seemed closest to his policy preference.

Mr. Brimmer said he considered the current economic situation about right. He thought the Committee was achieving its objectives and he was not at all concerned that the upturn in activity was something less than vigorous, since he thought some further moderation in the rate of inflation was needed. He was concerned, however, about the unduly rapid rates of growth in money and bank credit since mid-year and the related risk of creating expectations of excessive ease as in 1968.

Turning to the directive, Mr. Brimmer said his policy preference was best expressed by alternative C of the draft directives, although he could also accept a simplified version of alternative A. He noted that the Committee had made an overt move toward ease at its previous meeting, and he did not see any need to promote further easing. His language suggestions for alternative A would be to drop the proposed references to liquidity problems and to bank efforts to rebuild liquidity, which he found confusing. In reference to the questions which the Manager had raised about the interpretation of the money supply data and the weight to be given to the bank credit proxy, he (Mr. Brimmer) said he would treat the revisions in the former with a good deal of caution, particularly since final revisions were expected to be available within a few weeks. With regard to the bank credit proxy, he had noted earlier that its usefulness had been temporarily reduced because of the distortions created by problems in the commercial paper market, but since those problems appeared to have been largely resolved, he would return the credit proxy to a role of prominence along the lines suggested by Mr. Hayes.

Mr. Maisel said he was satisfied with the Committee's policy of the past three to four months--though not necessarily with developments in the economy--and he did not want to see any change in that policy. In terms of the money supply target, however, alternative A of the draft directives seemed to imply some tightening of policy and alternative B some easing. He would therefore suggest some revision of the language of the second paragraph, calling for "moderate growth in money over the second half of 1970 such as occurred in the first half." The new language might be incorporated into either alternative A or alternative B. The money supply was currently estimated to have grown at a 5-1/2 per cent annual rate in the first half, and he thought such a growth rate would be appropriate for the second half. It represented a target rate midway between those associated with alternatives A and B in the blue book.

Mr. Maisel added that it was fortunate the money stock had grown as fast as it did in the first half, and he did not think the time had arrived to cut back on the rate of expansion. He had in mind the fact that most sectors of the economy which were counted upon to provide some stimulus to over-all activity--such as housing, State and local government outlays, and plant and equipment expenditures--were interest and money elastic. Moreover, there was also the possibility of an inventory run-off, which as he noted earlier had not occurred thus far in contrast to the experience in other recessions.

Mr. Maisel said he would retain the references to liquidity in the second paragraph. Those references would help the Manager to interpret the meaning of the bank credit proxy by indicating the circumstances when he should pay more or less attention to that aggregate. The most important consideration, however, was to provide the Manager with a directive that would tell him how to stay on the current policy course in the 5-week interval until the next meeting. In that connection he would need to adapt money market conditions principally to developments in M_1, bearing in mind that the preliminary data were subject to revision. Thus, if growth in M_1 seemed to be falling short of the first-half rate, as he suspected might occur, he would have no objection to Desk operations designed to lower the Federal funds rate to around 6 per cent. In short, the Manager should be instructed to adjust his operations in keeping with developments in the monetary aggregates.

Mr. Daane indicated that, against the background of what he viewed as a sluggish economy, his preference would be to stay on the present policy course. In doing so, in light of his desire to see somewhat lower interest rates, he would probe gently and unobtrusively toward slightly easier money market conditions. His choice for the directive would be alternative A which Mr. Axilrod had interpreted as involving a shade easier credit market conditions than alternative C.

At the previous meeting, Mr. Daane continued, he had commented on the dangers of what he termed "monetary aggregates myopia." His concern on this score was heightened by the effort to differentiate between alternatives calling for growth rates in bank credit of 10 and 11 per cent, respectively. In his judgment such precision could not be justified by the state of the art and the Manager should not be instructed in those terms.

Mr. Heflin said there seemed to be general agreement around the table that the economy's current performance was less than satisfactory. The latest data suggested, at best, only a halting recovery from the recent slowdown, with prospects that real growth over the next two or three quarters would be well below potential. Judging from the discussion at the last three or four meetings, he would say that whatever disagreement existed within this group centered around attitudes toward that prospect. He was sure that everyone would like to see real growth move up promptly to the maximum rate that the economy could sustain without inflation. The only questions appeared to be, first, how fast the economy could be expected to move up to that maximum and, second, what role credit policy should play in that movement.

His present attitude toward those questions, Mr. Heflin continued, was tempered by the fact that the economy had just passed through a serious inflation, strong traces of which were still in evidence. He thought that several quarters of slow growth represented the price that had to be paid for purging that problem definitely from the economy. So far, he did not consider that the price had been excessive. Happily, the slowdown had been one of the mildest on record.

Mr. Heflin observed that in light of the recent revisions it now seemed that there had been considerably greater money growth in the first half of the year than the Committee had been assuming. That presumably implied that the lagged stimulative impact of policy would be correspondingly greater than the Committee had assumed. Under the circumstances and in view of the evidence that recovery, however halting, was under way, he would be reluctant to support alternative B or any variant that called for money growth in excess of 5 per cent per year. He understood that market prospects indicated that the Desk would have to take some positive easing action if the Committee was to stay on the 5 per cent target path in the weeks ahead. He would, of course, favor any easing designed to achieve that objective and he would welcome any rate reductions that might result. But he thought the Committee should avoid any aggressive efforts to bring market rates down. In particular, he thought the Committee should avoid creating the impression in the market that it was working toward a rate objective without regard to the behavior of the aggregates. Of the three alternative drafts it seemed to him that alternative A came closest to his position.

Mr. Clay commented that recent economic information further supported the view that some progress was being made toward the goal of orderly economic processes. A gradual though slow and somewhat uneven increase in economic activity appeared probable over the months ahead. Some slight improvement also had been made on the price inflation front, and progress toward reasonable stability of prices appeared attainable if the adjustment was made over a substantial period.

Mr. Clay added that the appropriate course for monetary policy continued to be that of moderate expansion in the monetary aggregates with such downward adjustment in money market rates as was compatible with that approach. A more aggressive policy toward providing added stimulus to economic activity would endanger the ultimate success of the price inflation battle. The prescription of policy was complicated by the problem of the measurement and specification of the monetary variables. That was illustrated by the current uncertainty as to the money supply data. That problem underscored the hazard involved in exclusive reliance upon any single variable as the guide to policy.

Mr. Clay also noted that the developments in bank credit deserved careful consideration at this juncture. The recent rate of bank credit expansion was much too high to be permitted to continue. It was recognized that that development was by no means confined to transfers of credit from market to banking channels. "Allowing bank credit growth to reflect bank efforts to rebuild liquidity" as referred to in the draft directives raised the question of the appropriate extent and speed of that process. The staff projections of bank credit growth accompanying the directive drafts indicated much smaller expansion than in recent months, but there was no assurance as to what the actual rates of growth might be.

The policy associated with draft directive B appeared to Mr. Clay to be too expansionary. Alternative A as shown in the blue book was more appropriate, provided close attention was given to the rate of bank credit expansion. He would therefore be prepared to support a modified version of alternative A and he could also accept alternative C. He thought the money supply projections were acceptable, but understandably there was substantial uncertainty as to what were the correct money supply data. Moreover, there was the further question as to whether the broader money supply approach might not be more applicable to the present situation of rapid time deposit growth through reserves provided by the Federal Reserve.

Mr. Mayo said he found himself in basic agreement with the interest rate objectives associated with alternative B, although his language preference for the directive would be an amended version of alternative A. He felt a moderate degree of satisfaction with the achievements of monetary policy under recent directives, but he would have preferred a little more expansion in the money supply during the third quarter and less firming in credit markets in recent weeks. Perhaps those preferences reflected his natural inclination to emphasize money market conditions in the directive rather than the monetary aggregates. In that connection, he would agree with Mr. Daane that there were pitfalls in the tendency to become overly precise in specifying targets for the monetary aggregates.

Mr. Mayo noted that he would amend alternative A by inserting the word "further" in the first sentence which would then read in part: "the Committee seeks to promote some further easing of conditions in credit markets." He thought that language would express a desirable sense of continuity in the process of achieving the Committee's goals. In his view the latter had not been fully achieved thus far, possibly because policy had not been eased quite enough. While he did not want the System to get in a position of paying too much attention to interest rates, he thought the Committee should undertake to press a little further toward ease within the constraints of alternative A, as amended. He would also revise the language of alternative A in line with the suggestions Mr. Brimmer had made earlier. In general, Mr. Mayo added, his preference would be to formulate the directive along the lines of alternatives A and B rather than C because he believed an instruction relating to market conditions should precede the instruction referring to the monetary aggregates.

Mr. Galusha observed that the same directive had been used today to support quite different philosophies regarding the objectives of the Committee's operations. He found himself in agreement with many of the comments made by both Mr. Maisel and Mr. Mayo, but he did not share their directive preferences. In particular, he favored continuation of money growth at about the first-half rate of 5-1/2 per cent. Since alternative A was associated with a lesser rate of growth, his directive preference would be alternative B.

Mr. Swan said he was in agreement with Mr. Maisel regarding the desirability of continuing on the present policy course, but given the uncertainties in the data for the monetary aggregates he would resolve doubts on the side of ease. In his view alternative B called for too overt a move toward ease and he thought his policy preference could be accommodated by alternative A without Mr. Mayo's suggested addition of the word "further" in the first sentence. As to bank credit, he thought the various qualifications contained in the staff drafts of alternatives A and B would cancel out any weight that might otherwise be given to that aggregate by the Manager in his operations. He therefore favored dropping the references to bank credit presently incorporated in draft alternatives A and B and inserting instead a reference to "moderate growth in bank credit," such as Mr. Hayes had suggested in connection with alternative C. He (Mr. Swan) would not, however, be in favor of alternative C.

Mr. Coldwell indicated that in his view the Committee's emphasis on the monetary aggregates as operational targets was not accomplishing the desired objectives. On the other hand, he did not think there was much that monetary policy could do in the coming 5-week period beyond lending stability to the markets during the automobile strike. He certainly would not support any overt easing of monetary policy and his choice for the directive would therefore be consistent with some version of alternatives A or C. However, he would prefer to have the reference to money market conditions inserted as the first and primary instruction to the Manager. He also believed that bank credit should be given increasing emphasis as time went on. Finally, he would reiterate Mr. Eastburn's view that the System should proceed cautiously before deciding upon any change in the discount rate.

Mr. Morris indicated that if he had to choose between alternatives A and B, his preference would be alternative B because it represented a more expansionary policy course. However, he was not at all satisfied with the present form of that alternative. Indeed, he was very much concerned about what he regarded as a rapid deterioration in the form of the directive over the past few months. In its earlier form he thought the directive had been a model of brevity and clarity, but he viewed the two current staff drafts as imprecise and ambiguous. Specifically, he thought there were three major ambiguities in the present drafts. First, they gave the Manager two co-equal objectives but did not assign any priorities in the event that those objectives should prove incompatible. For example, the instruction in alternative B called for "some further easing of conditions in credit markets and somewhat greater growth in money over the months ahead than occurred in the first half." Should it prove impossible to implement both objectives simultaneously in the period ahead, the Manager would have to make his own decision about priorities. Secondly, he did not understand the meaning of the reference to "bank efforts to rebuild liquidity" despite the staff effort to offer an explanation in the notes accompanying the draft directives.[1/] As a practical matter he felt the reference would have the result of instructing the Manager to ignore bank credit and to concentrate on the money supply in implementing such a directive. Thirdly, he was not sure what objective was referred to in the final sentence of each alternative, since several objectives were implied by the previous statements.

Mr. Morris added that, while he was not interested in literary quality per se, he thought that imprecise directives tended to impair communication between the Committee and the Manager and among Committee members. Such a directive could lead to errors in policy, particularly when multiple targets were involved and were found to be divergent. He understood the desirability

1/ The staff note referred to by Mr. Morris read as follows: "A reference to bank efforts to rebuild liquidity is proposed for insertion in view of the apparent substantial liquidity preferences of banks as a factor conditioning their lending and fund raising behavior. Bank activities of this type appear to be developing into a significant influence on the growth of the credit proxy in addition to the earlier influence of investor shifts of funds from market to banking channels."

of reaching a consensus and had heard the argument that an ambiguous directive facilitated that process. But he also thought it was important not to give the impression of a consensus where in fact none existed and he feared a directive like the staff drafts today ran that risk.

Chairman Burns observed that any ambiguity in the directive was significantly reduced as a practical matter by the fact that the Manager could draw upon the Committee's entire discussion in arriving at an understanding of its wishes.

Mr. Robertson then made the following statement:

> I come back from vacation with two particular impressions that I formed from a variety of personal conversations. Both involve people's attitudes towards inflation.
>
> It seemed to me I met relatively few people who were full of inflationary spending intentions. That is, I did not find many who were eager to spend now in anticipation of higher prices later. But I did find a great many people full of inflation worries. By that I mean they were deeply concerned--even fearful--that price advances would continue irresistibly to eat away at values.
>
> The green book, I know, describes the growing body of evidence that we are making some headway in the struggle against inflation. Curing inflation like we have had, however, takes time, and the general public has to be forgiven for not being persuaded until it finally sees price tags stop changing. We all know it will be many months before that can happen, and some delicate transitions have yet to be accomplished. We cannot let the economy slip too far--that would be a waste of resources--but we also have to keep determinedly at our task of getting back to a path of noninflationary prosperity. That, I think, remains the critical challenge to monetary policy. We should not waver from that course when we reap the consequences of pursuing such a policy, especially when the policy goals are beginning to be reached.

> I believe monetary policy ought to strive for a cautiously expansionary track, such as we have been on for some time now. To me, the most desirable set of conditions would be a money supply growth averaging around five per cent for the time being, a gentle downdrift of interest rates, and bank credit growth gradually slowing from its recent accelerated pace of advance. That combination is what I would like the Manager to try to approximate. I believe directive draft alternative A, if cleaned up (or alternative C) promises to come closest to promoting this objective. I would be prepared to vote for A, or in the alternative, for C.

Chairman Burns said he thought today's roundup of views on policy had been especially good. A majority of the Committee leaned towards alternative A of the draft directives and that alternative was also his preference. The policy pursued over the past few months had not always satisfied every member and the wording of past directives had left something to be desired, but by and large he believed the Committee's policy had been on a sound track and should be continued. In his view alternative A would accomplish precisely that objective.

The Chairman said he did not believe the Committee should change its directive from month to month unless there was a clear reason for the change. Alternative A, he thought, continued the spirit of the directive issued at the previous meeting. He recognized that there were some defects in the draft language of that alternative, and he wanted to propose a simpler version which might meet some of the objections to the present draft that had been raised today. The language he had in mind was as follows:

"To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective."

Mr. Hayes said he would prefer alternative language calling for slightly easier money market conditions than had prevailed on average since the previous meeting instead of language to indicate the Committee wanted to promote some easing of credit conditions. He wanted to avoid language calling for progressive easing of credit conditions since he feared the possible inflationary effects of such a policy.

Chairman Burns said he would not have any objection to Mr. Hayes' proposed alternative wording. He noted that the Committee members might have differing judgments about whether or not a recovery was under way and about the speed of a possible recovery in the months ahead, but he thought they were all relying chiefly on residential construction and on State and local government expenditures, particularly construction outlays, to stimulate economic activity. Both sectors were especially sensitive to interest rates, and although the point had not been articulated, he thought it was in the minds of the majority who were in favor of some easing in credit market conditions. In his judgment, it would be a mistake to freeze interest rates at their present levels, and a move toward somewhat lower rates over the next few months would simply be to continue on the policy course the Committee had already adopted. As long as such a policy was pursued, he did not think the precise language of the directive was important.

Mr. Daane said he did not see any real difference between the language Chairman Burns had read and the substitute language Mr. Hayes had proposed.

After some further discussion, Chairman Burns asked for a show of hands on the alternative language proposals having reference to market conditions and most of the members indicated a preference for the wording suggested by the Chairman.

There followed a general discussion of the directive proposed by Chairman Burns. Mr. Francis observed that the first sentence seemed to imply a conclusion on the part of the Committee that the period of rapid reintermediation related to the difficulties in the commercial paper market was now over. His own preference was to concentrate on the appropriate growth rate in the money supply. Mr. Hayes suggested that the last sentence, referring to bank reserves and money market conditions, might be redundant with the reference in the first sentence to "credit market conditions." It was agreed that the matter, and the possible need for a revision, would be resolved by Chairman Burns and Mr. Hayes with the assistance of the staff.

Mr. Holmes asked whether the reference to "credit market conditions" in the directive was meant to apply only to interest rates or to interest rates and the availability of funds in the market.

In the discussion which followed, Chairman Burns said he thought the primary focus was meant to be on interest rates, meaning the whole family of rates. Mr. Maisel noted that the Desk's operations normally had their immediate and direct impact primarily on the Federal funds rate and only indirectly on other market interest rates. To the extent, however, that the Committee agreed that the direction of movement of other rates was important, the Manager ought to use the movements in other interest rates as a major criterion in his day-to-day attempts to influence the Federal funds rate. Mr. Daane observed that interest rates could not be separated from the availability of funds, and the Chairman said an improved availability of funds would be part of the over-all picture.

The Chairman then suggested that the Committee vote on the directive with a first paragraph consisting of the staff's draft and the second paragraph consisting of the draft he had proposed, subject to possible revision of the last sentence as agreed earlier.[1/]

> With Mr. Hayes dissenting, 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 real economic activity, which edged up slightly in the second quarter, is expanding somewhat further in the third quarter, led by an upturn in residential construction. Wage rates generally are continuing to rise at a rapid pace, but improvements in productivity appear to be slowing the

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1/ It was decided following the meeting that no revision would be needed in this sentence.

rise in costs, and some major price measures are rising less rapidly than before. Interest rates declined in the last half of August, but most yields turned up in early September, as credit demands in securities markets have continued heavy; existing yield spreads continue to suggest concern with credit quality. The money supply rose rapidly in the first half of August but moved back down through early September. Bank credit expanded sharply further in August as banks continued to issue large-denomination CD's at a relatively rapid rate, while reducing their reliance on the commercial paper market after the Board of Governors acted to impose reserve requirements on bank funds obtained from that source. The balance of payments deficit on the liquidity basis diminished somewhat in July and August from the very large second-quarter rate, but the deficit on the official settlements basis remained high as banks repaid Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective.

Chairman Burns noted that the next item on the agenda for discussion was a memorandum from the Secretariat, dated September 4, 1970, regarding Federal Open Market Committee meeting schedules for 1971 and later years. The question at issue was whether to schedule 12 or 13 meetings during the year.

Mr. Robertson said he understood the staff considered the choice important from the standpoint of providing information to the Committee. On that basis he thought 12 meetings would be preferable to 13.

Mr. Hayes said the Committee had experimented by cutting its schedule to thirteen meetings, and he thought that schedule had proved workable. He said no reason, however, why the Committee should not make another experiment. It could always go back to thirteen meetings if that were found to be preferable.

Mr. Maisel said the essential difference was not in the number of meetings but in the number of 5-week intervals between meetings. With a twelve-meeting schedule there were four or five intervals of five weeks each year and he did not think that was desirable. He therefore preferred the thirteen-meeting schedule.

An informal poll of the members of the Committee and the other Reserve Bank Presidents showed an even division between those favoring a 13-meeting schedule and those favoring 12 meetings each year. It was decided to leave the decision to Chairman Burns.[1/]

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, October 20, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

1/ Notice was sent to the Committee, under date of October 5, 1970, that the Chairman had decided on the four-weekly or 13-meeting schedule for 1971, and that the tentative meeting schedule was as follows:

January 12	May 4	August 24
February 9	June 8	September 21
March 9	June 29	October 19
April 6	July 27	November 16
	December 14	

ATTACHMENT A

CONFIDENTIAL (FR) September 14, 1970

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 15, 1970

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real economic activity, which edged up slightly in the second quarter, is expanding somewhat further in the third quarter, led by an upturn in residential construction. Wage rates generally are continuing to rise at a rapid pace, but improvements in productivity appear to be slowing the rise in costs, and some major price measures are rising less rapidly than before. Interest rates declined in the last half of August, but most yields turned up in early September, as credit demands in securities markets have continued heavy; existing yield spreads continue to suggest concern with credit quality. The money supply rose rapidly in the first half of August but moved back down through early September. Bank credit expanded sharply further in August as banks continued to issue large-denomination CD's at a relatively rapid rate, while reducing their reliance on the commercial paper market after the Board of Governors acted to impose reserve requirements on bank funds obtained from that source. The balance of payments deficit on the liquidity basis diminished somewhat in July and August from the very large second-quarter rate, but the deficit on the official settlements basis remained high as banks repaid Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money over the months ahead, while taking account of possible liquidity problems and allowing bank credit growth to reflect bank efforts to rebuild liquidity and any continued shift of credit flows from market to banking channels. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective.

Alternative B

To implement this policy, the Committee seeks to promote some further easing of conditions in credit markets and somewhat greater growth in money over the months ahead than occurred in the first half, while taking account of possible liquidity problems and allowing bank credit growth to reflect bank efforts to rebuild liquidity and any continued shift of credit flows from market to banking channels. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective.