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 Monday and Tuesday, June 18-19, 1973, beginning at 4:00 p.m. on Monday.

PRESENT: Mr. Burns, Chairman 1/
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Holland
Mr. Mayo
Mr. Morris
Mr. Clay, Alternate for Mr. Balles
Mr. Debs, Alternate for Mr. Hayes

Messrs. Eastburn, Kimbrel, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. MacLaury and Coldwell, Presidents of the Federal Reserve Banks of Minneapolis and Dallas, respectively

Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Nicoll, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Bryant, Eisenmenger, Gramley, Hersey, Scheld, and Sims, Associate Economists
Mr. Sternlight, Deputy Manager, System Open Market Account
Mr. Bodner, Deputy Special Manager, System Open Market Account

Mr. O'Brien, Special Assistant to the Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors

1/ Entered the meeting at the point indicated.

Messrs. Gemmill and Pizer, Advisers, Division of International Finance, Board of Governors
Mr. Zeisel, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Stockwell and Messrs. Ettin and Taylor, Assistant Advisers, Division of Research and Statistics, Board of Governors
Mrs. Junz, Assistant Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Messrs. Peret and Wetzel, Senior Economists, Division of Research and Statistics, Board of Governors
Mr. Roxon, Senior Economist, Division of International Finance, Board of Governors
Messrs. Enzler and Wyss, Economists, Division of Research and Statistics, Board of Governors
Miss Morisse and Mr. Smith, Economists, Division of International Finance, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Peters, Secretary, Office of the Secretary, Board of Governors

Messrs. Black and Williams, First Vice Presidents, Federal Reserve Banks of Richmond and San Francisco, respectively
Messrs. Boehne, Parthemos, Taylor, and Doll, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Richmond, Atlanta, and Kansas City, respectively
Messrs. Hocter and Green, Vice Presidents, Federal Reserve Banks of Cleveland and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Davis, Adviser, Federal Reserve Bank of New York

Mr. Broida noted that the Committee's Rules of Organization stated that "in the absence of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board, the member of the Board present with the longest service as a member of the Board acts as Chairman." Chairman Burns was unavoidably detained and Vice Chairman Hayes and Mr. Mitchell would not be attending today's meeting. Mr. Daane was the Board member present with the longest service.

Mr. Daane said that, on behalf of the Committee, he wished to welcome Mr. Holland to his first meeting as a member. He also welcomed Mr. Debs, who was attending his first meeting as Mr. Hayes' alternate, and Mr. Williams, who was attending in the absence of Mr. Balles. He then noted that this Monday afternoon session had been called to provide adequate time for consideration of the economic outlook and longer-run targets for monetary policy. He asked Mr. Partee to begin the staff presentation.

Mr. Partee made the following statement:

> Today the staff is presenting its first judgmental projection of the economy reaching into 1974. We have extended our analysis to cover the year as a whole, not because of any high degree of confidence in our foresight, but because the economy seems certain to be in process of transition over the months to come. Therefore, it seems desirable to attempt to trace out the most likely outcome of this transition and to assess the implications for that outcome of the economic policies assumed.
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> It is certainly no overstatement to assert that, at this time, we face extraordinary uncertainties in evaluating the outlook. Thus far this year, we have witnessed a nearly runaway inflation; unsustainable growth of demands in product markets; growing pressures on industrial capacity; supply shortfalls in strategic sectors; successive

waves of international speculation against the dollar; a notably weak stock market; and uncertainty and apprehension about the stability of our political leadership. Confidence has been badly battered.

Notwithstanding the current uncertainties, we believe the economic upsurge is even now showing moderating signs. And we believe that economic growth--in both nominal and real terms--is likely to slow markedly and progressively in the quarters ahead. But because of the short-run risk of economic overheating and the clear and present danger of continuing unacceptable rates of inflation, our projection deliberately assumes the continuation of relatively restrictive monetary and fiscal policies, not only for the remainder of 1973 but on through 1974.

With respect to monetary policy, we assume that M_1 will remain on a 5-1/4 per cent growth path throughout the projection period. Under such a policy, the trend toward higher interest rates is likely to be extended, and in order to help maintain reasonable savings inflows to the depository institutions, we have assumed a 50 basis point increase in ceiling interest rates on consumer-type time and savings deposits, effective before the end of June.

As for fiscal policy, we have assumed that the Administration will be reasonably successful in limiting Federal expenditures, as it has been over the past fiscal year. We have added about a billion dollars to the fiscal 1974 expenditure estimates that were in the mid-year budget review, to allow for some slippage on the impoundment issue, and we have also added an unscheduled 10 per cent boost in social security benefits, effective in mid-1974. Even so, fiscal policy is expected to be moving in a restrictive direction, with a rather sizable surplus developing on a full employment basis over the course of 1974.

Our last policy assumption, as to the continuation of Phase III controls, is already obsolete. But the new program announced by the President last week is clearly of a temporizing character. The price freeze of up to 60 days should depress the third-quarter price deflator well below what we have projected, and the export control authority--if granted by Congress--could conceivably have a more lasting impact on domestic prices and export volume. Whether our basic outlook for continuing wage and price pressures is likely to be invalidated by action on controls, however, will depend on the contents and acceptance of a Phase IV program that is not yet determined. The initial reception in financial markets to last week's announcement does not suggest that it has succeeded in shifting the present state of public psychology.

We have decided, therefore, to proceed with our economic projection as it was developed before the President's announcement, and we will stand ready to revise our thinking later on when the Phase IV details are specified and can be assessed.

Mr. Gramley made the following statement:

Economic activity has continued to expand at a robust pace during the first half of 1973. Industrial production has increased at an 8-1/2 per cent annual rate since last December, led by rising durable goods output. Employment in manufacturing and other industries has continued to grow at a substantial pace. Retail sales in real terms rose sharply through March, but since then have tailed off. New construction has also declined recently, but that is scarcely surprising, given the large increase of output in this sector since mid-1970.

Our staff continues to project slower real GNP growth this quarter than the 8 per cent rate of the first; recent smaller gains in production and employment seem to confirm that expectation. Nevertheless, the underlying strength of the current expansion remains impressive. If our second-quarter projection is correct, real GNP will have grown at around a 6 per cent annual rate or above for seven successive quarters.

Leading indicators suggest, moreover, that the pace of expansion will remain relatively vigorous for a time. Average overtime work in manufacturing has risen to around 4 hours per week--near the highs of early 1966--as producers have attempted to keep up with rising customer demands. In many industries, the lines of waiting customers are lengthening. Thus, the series on vendor performance--that is, the proportion of company purchasing agents in and around Chicago reporting slower deliveries--has risen to a postwar peak. Unfilled orders for durables have increased more than 10 per cent since the first of the year, and the aggregate inventory-sales ratio has fallen to an unusually low level. New orders for nondefense capital goods, meanwhile, have risen substantially further this year. Activity in the industrial sector thus appears likely to continue rising at a good pace for some months yet.

In residential construction, a decline in output does seem indicated by the downturn in building permits. We learned earlier today, however, that permits rose slightly in May, and that housing starts were up 15 per cent over April.

Despite numerous signs of near-term strength, a substantial number of forecasters expect a recession or a period of economic weakness to develop beginning in late 1973 or in 1974. The basis for this expectation merits careful review.

An important consideration is the speed with which real output is approaching the full employment potential. Real GNP this quarter will probably be around 98 to 98-1/2 per cent of the full employment potential--depending on whether a 4 per cent or a 4-1/2 per cent unemployment rate is used to define potential output. In either case, however, output cannot continue to grow much longer at the average rate of the past 2 years. A significant retardation will have to occur soon, and the process of slowing may produce imbalances that set the stage for a later downturn.

One possible source of imbalance is in the aggregate relation between consumption and business fixed investment. Real personal consumption expenditures continued to grow slowly during the recession of 1970, but the pace of these outlays picked up in 1971, and consumer buying has remained strong through the early months of this year. Business fixed investment in constant prices remained in the doldrums until late in 1971, but since then the rapid upsurge in these outlays has just about restored their prerecession relationship with consumption.

These developments call to mind the cyclical expansion of the mid-1950's. Then, as now, a boom in consumer spending for autos and other durables helped to trigger a sharp acceleration in business capital spending. When the rise in real consumption moderated, the basis for large additions to the real capital stock was weakened. Growth in real investment then slowed materially, and finally turned down.

The question at issue now is whether the pace of real consumption will once again taper off and thereby induce businesses to moderate investment outlays. Some dampening in consumption seems likely, given the substantial runup in durable goods outlays and in instalment credit over the past 2 years.

The boom in sales of autos and other durables has raised to over 15 per cent the proportion of disposable income spent on consumer durable goods. This is the highest ratio of the postwar period. In the auto buying spree of the mid-1950's, consumer spending for hard goods cooled appreciably when the ratio to after-tax income approached current levels.

Then, as now, the boom in consumer durables was financed by a surge in consumer credit that increased the share of disposable income absorbed by instalment debt repayments. This ratio has trended upward over the postwar period, and its level presently is well above that of the mid-1950's. More importantly, the increase in this ratio has been substantial over the past 2 years, and during this period, mortgage debt of American families has also risen rapidly.

If rising debt service or depleted backlogs of demand for durables do not succeed in cooling off consumers' spending, waning confidence may. All of the three major consumer surveys indicate increased uneasiness about the future. The Michigan Survey Research Center's index of consumer sentiment appears to be the most reliable of the three as a guide to consumer buying. This index began to turn down last fall, and since then has declined steeply, to near the 1970 recession low.

The behavior of the stock market provides additional evidence of deteriorating attitudes--of investors as well as consumers. Stock prices are still well above the 1970 recession trough, but the gains of 1972 were all wiped out by the sharp selloff over recent months, which has continued through today--even after last Wednesday's announcement of a new price freeze. Declining stock prices are more than a symptom of public attitudes. Among other things, they are a consequence of using monetary restraint to cool economic overheating. When equity prices fall as sharply as they have recently, however, there is the danger of a serious loss of confidence in the future--with potentially destructive effects on economic expansion.

In assessing the economic outlook, many forecasters are also concerned with the consequences of monetary and fiscal restraint. Early this year, the real money stock--nominal M_1 divided by the CPI--declined, as growth in nominal money slowed and the rate of inflation worsened. Growth in nominal M_1 was larger in the second quarter, but a rapid rate of price advance held down the real increase.

If M_1 were to grow on a 5-1/4 per cent path through the remainder of 1974, as we assume, and if the average rate of price increase were in the 4 to 5 per cent range, real money balances at the end of 1974 would be only fractionally above their level at the end of 1972. This would not be as restrictive a course of monetary policy as that pursued in 1966 or 1969 when the real money stock declined, but it would likely take its toll in housing and other lines of activity.

On the fiscal side, the full employment budget is projected to be moving into surplus late this year, and the size of the surplus should increase in 1974. In assessing the impact of fiscal policy, it is worth noting that Federal purchases, in real terms, are expected to show little if any growth in the next year and a half. Thus, there would be no offset from Federal purchases if private demands for goods and services did, in fact, weaken.

In developing a GNP projection for 1974, our staff has faced formidable uncertainties. Many economic indicators are still pointing rather strongly upward. But economic growth has begun to slow, and of late the indicators have begun to look a bit more spotty. Unfortunately, there is no way of ascertaining when the outlook will begin to show clearer signs of softening, or how significant an adjustment may be ahead.

In developing our projection, therefore, we have had to rely heavily on past cyclical experience, as well as our econometric model. Both suggest that the road ahead is likely to be rocky. But there are a variety of plausible projections for 1974 that could be defended; the one we are about to present seems plausible, but the uncertainties surrounding the estimates are much greater than usual.

Chairman Burns entered the meeting during the course of Mr. Gramley's presentation.

Mr. Wernick made the following statement:

Our view of prospective developments is that there will be an appreciable slowing in economic growth over the next year and a half. We expect nominal GNP growth by the fourth quarter of this year to be down to a $27 billion rate, reflecting a downward trend in housing activity, marked slowing in the growth of consumer spending, and some tapering off in the current capital spending boom.

Further weakness is envisioned in 1974 because of a projected turndown in inventory investment, additional curtailment in the growth of capital spending and further declines in residential construction. We are projecting a reduction in the real GNP growth rate to about 3.5 per cent by the end of this year and to about one per cent in the latter part of 1974. If our outlook is correct, the economic growth rate in 1974 would be well below the nation's long-run potential.

Consumer spending has been a major factor in the current boom, though in the last 2 months there has been some faltering in retail sales. Growth in consumer spending is projected to deteriorate over the remainder of this year as gains in disposable income weaken following completion this month of tax refunds. We have also assumed that the pessimism indicated in recent surveys will dampen consumer spending. Our estimates for the near future could prove to be too low, however, if the current price freeze acts to spur consumer buying in anticipation of a later bulge in prices.

Consumer spending is likely to be strengthened again by another round of tax refunds early in 1974, but the effect would be temporary, in an environment of slowing growth in jobs and income. The saving rate is expected to fall appreciably in the latter half of this year, after tax refunds are completed, and to remain at relatively low rates in 1974--reflecting the slow growth of disposable income.

Declining auto sales are expected to be an important factor contributing to the weakness in consumer spending. Auto sales are projected to drop below a 10 million rate by the end of next year--to 8 million for domestic-type cars. Imported car sales are also expected to fall, reflecting, in part, relatively higher prices as a result of dollar devaluation. But the level of auto sales we have projected for 1974 would still be high by historical standards and consumer expenditures for durable goods relative to total GNP would continue to be considerably above the ratio in other comparable periods of economic expansion.

Business fixed investment has contributed importantly to the momentum of the current boom, and further substantial growth is anticipated this year. We have projected about a 17 per cent advance in business fixed investment for 1973, well above the gain shown for 1972 and also considerably above the increase indicated by the recent Commerce survey of anticipated plant and equipment spending.

We have done so because manufacturers' shipments of business capital goods and construction activity data suggest a larger increase in business fixed investment in the second quarter than shown by the Commerce survey. And data on new and unfilled orders for business capital goods, construction contract awards, and manufacturers' capital appropriations also point to the likelihood of higher rates of business fixed investment spending in the last half of the year.

Nevertheless, the capital outlays we have projected imply some tapering of the growth of such spending as the year progresses, and it seems plausible that businessmen will become more cautious as evidence develops that the rise in activity is leveling off. A further moderation in capital outlays is projected for next year as overall demands ease, gains in profits are curtailed and pressures on plant capacity become less intensive. Indeed, real growth in business fixed spending is projected to come to a halt after mid-1974.

It now seems highly probable that housing activity will decline over the course of the next year and a half. We project a slide to a 1-3/4 million unit rate by mid-1974 before starts begin to level off. As a consequence, expenditures for residential structures are projected to drop 13 per cent between 1973 and 1974.

In large part the decline in housing activity is a reflection of an easing in demand factors. Following the past 2 years of exceptionally high housing starts, completions are now rising at a rapid rate relative to anticipated demands. In addition, however, mortgage credit conditions are expected to constrain building in the period ahead. Flows of savings to mortgage lending institutions have already begun to slow, lenders have begun to tighten terms, and a downturn in mortgage commitment volume now seems to be under way.

With the rise in final sales slackening, inventory increases are expected to be a more important source of strength through the remainder of this year. Businessmen are expected to build up stocks from depleted first-quarter levels, so that by the end of 1973 inventory investment would reach an annual rate of around $18 billion. Inventory investment is then projected to turn down and, reflecting a leveling in final sales, to drop gradually to a rate of accumulation of around $10 billion by the end of 1974.

The moderation in inventory investment that we project is relatively small by past standards, in part because inventory sales ratios have been at record low levels. This inventory pattern implies only a small rise in stocks relative to sales and inventory-sales ratios are projected to remain well below the 1969-1970 period.

Our fiscal policy assumption, as earlier noted, requires a relatively tight rein on Federal spending and would bring a shift in the NIA budget from deficit to surplus in coming quarters. Total NIA expenditures from now to the end of 1974 are projected to rise at about an 8 per cent annual rate. At the same time, growth in revenues along with higher social security taxes are expected to increase Federal income rapidly over the remainder of this year, and the NIA budget shows a surplus by the fourth quarter. In 1974, however, receipts are affected by the projected slowdown in the growth of income, and the NIA budget is expected to move into slight deficit by the second half of the year.

The full-employment budget, of course, is not influenced by the economic slowing, and it shows a continued shift toward surplus. This surplus, however, is partly attributable to the impact on receipts of continued inflation.

We translate expenditure restraint to mean only relatively small further increases in Federal purchases of goods and services in 1974. Defense expenditures are projected to remain essentially flat.

By contrast, State and local governments are projected to increase their purchases at about a 10 per cent annual rate in 1973 and again in 1974. This would add about $20 billion each year to State and local purchases. These relatively high spending projections reflect a judgment that the proceeds of revenue sharing will influence State and local programs more noticeably with the passage of time. Also, we have assumed some release of impounded funds that would add to State and local expenditures.

When growth in the economy slows, there is generally a greater impact on demands for goods than for services. Consequently, gains in industrial production are likely to slow more sharply than those for real GNP in 1974. By the middle of next year we would anticipate little, if any, further gain in industrial output, so that demands for labor in manufacturing and other industrial sectors would likely be easing.

Mr. Zeisel made the following statement:

Growth of real GNP, though moderating, is projected to continue to support employment gains sufficient to reduce unemployment to about 4.8 per cent in the second half of this year. Thereafter, however, weaker economic growth is likely to mean slower employment growth. Overall, we are projected an increase in nonfarm employment of about a million between the fourth quarters of 1973 and 1974, as compared with about 2-1/4 million in the current year. Typically, manufacturing employment bears the brunt of any slowdown of a cyclical nature, and a drop of 400,000 factory jobs is projected over the course of 1974.

Growth in the labor force is also projected to slow as employment opportunities weaken. But we still expect a fairly sizable increase of over 1-1/2 million in 1974--about equal to so-called normal gains--for several reasons. First, we are not projecting a full recession in 1974. Second, the working-age population is in a period of accelerated growth and an increasing portion of the additions are now among young adults who have firmer attachment to the labor market than teenagers. Finally, high and rising consumer prices tend to put considerable pressure on second wage-earners--particularly married women--to stay in the job market. With the gain in the labor force projected to exceed that of employment, we would expect the unemployment rate to turn up by early 1974 and then to rise gradually to a level of about 5-1/2 per cent by the end of the year.

Turning to wage developments, we may note, first, that the rate of increase has been surprisingly moderate so far this year, despite the very sharp rise in prices. The index of average hourly earnings for private nonfarm workers thus far in 1973 is running slightly over 5-1/2 per cent above last year--about half a percentage point less than the rate of increase in 1972. Although tending upward somewhat in recent months, wage increases in trade and services remain well below earlier highs, probably reflecting the persistence of labor reserves in these markets. Manufacfacturing earnings have also continued up at a relatively slower pace, and recent key wage settlements have shown little tendency toward wage escalation, although in some cases pensions and other fringes have been increased substantially. These recent moderate wage contracts are probably due in part to the reduced rate of price rises last year, which translated gains in gross earnings into a strong growth in real spendable earnings, after several years of no improvement at all. But the situation is now markedly different. Gross weekly earnings have continued to move up, but real spendable earnings of private nonfarm workers have fallen since late last year. An increase in Social Security taxes at the beginning of 1973 is partly responsible, but the main factor has been the acceleration of inflation.

This loss of real take-home pay seems very likely to provoke demands for larger wage settlements. A widespread interest in cost of living escalators has already been evident as one response to rising consumer prices. Given the adjustment lags in unionized sectors, we expect only a slightly more rapid rise in manufacturing wages for the remainder of this year. But factory wages are projected to accelerate in 1974, reaching about a 6-1/2 per cent rate by late in the year. Wages are expected to move up sooner in the relatively less unionized trade and service sectors, responding to recent price increases, to increases in the minimum wage that we assume will take effect this autumn and again in the fall of 1974, and to the expected further tightening of the labor market later this year. These basic forces could generate a rise in the average hourly earnings index for all nonfarm industries to an annual rate of close to 7 per cent by the latter part of 1974. As indicated earlier, these projections do not take into account the impact of the current freeze and possible Phase IV developments.

Compensation per manhour in the private nonfarm economy, which includes salaries and fringe benefits, seems certain to continue upward at a faster pace than wages in the period ahead. We expect that compensation costs will be elevated not only by rapidly growing fringe benefits, but also by an increase in employers' contributions to social security scheduled for January 1 of next year.

A quantitatively more significant factor affecting unit labor costs next year, however, is likely to be a slowing in the rate of growth of productivity. There has been relatively little variation in the rate of increase of compensation per manhour in the past several years. Virtually all of the improvement in the trend of unit labor costs was a product of the improved productivity performance that accompanied stronger gains in real output. But we are now entering a period when productivity growth is likely to be slowing sharply, along with the slowing of growth in activity, and thus providing less of a buffer against increases in wage rates. With unit compensation moving up and productivity deteriorating, labor costs could be increasing on the order of 6 per cent in 1974--substantially above recent average rates of rise.

Productivity gains are quite sensitive to changes in rates of economic growth. After slipping below trend during the recession of 1969-70, output per manhour began a cyclical recovery which brought the index above trend by early 1973. Our expectations are that the marked slowing in real economic growth is likely to bring the productivity index about back to trend again by the end of 1974.

As productivity growth slows, larger cost increases are likely to create fundamental problems in any Governmental effort to dampen inflationary pressures. Over-all price movements have tended broadly to conform to changes in unit labor costs, although the swings have not been as great. We believe that the rate of price increase in 1974 could lag somewhat behind the run-up in costs, reflecting reduced demand pressures and a probable slowing in the rate of rise of food prices. For foods, much will depend on the state of this year's harvest and the possible impact of proposed export controls. The chances of appreciably larger meat supplies have been reduced over the forecast period by sharply higher feed prices, and it thus seems possible that food prices may well continue to move significantly higher, although certainly at less than recent rates.

The extent of price inflation in 1974 will, of course, also depend on a number of imponderables, including what may be done to the controls program under Phase IV. But unless wage increases are brought under stricter control, an acceleration in labor costs is likely tc put considerable additional pressure on prices. On the other hand, greater availability of materials and weaker final markets as demand slackens should tend to dampen price increases somewhat.

On balance, we expect the rise in prices to slow appreciably in the second half of this year from the extremely rapid first-half rate, largely as a result of moderating increases in food prices--and now, of course, the impact of the price freeze on the third-quarter rate. Thereafter, we are projecting a rate of rise in the private fixed-weight price index of about 4-3/4 per cent in the first half of 1974 and a slightly lower rate of increase in the latter part of the year. These increases are, on average, more than a percentage point below the projected rise in labor costs and do not seem inconsistent with some incremental effect from a continued program of price control.

Mr. Bryant made the following statement:

Our presentation today has had to take into account the large uncertainties that cloud the outlook for the U.S. economy. Equally severe uncertainties make it difficult to assess the outlook for international transactions. In addition to the usual questions about economic and policy developments in leading foreign countries, we face new uncertainties about exchange rates and their effect, about crop prospects and primary product prices, and about the effects of a possible phasing out of U. S. controls on capital movements.

In these circumstances, it seems most fruitful to focus the international section of our presentation mainly on the prospects for merchandise exports and imports.

Rising foreign demand for U. S. exports has been an important expansive force for the U. S. economy during the past two years. From the second quarter of 1971 to the first quarter of this year, when the value of goods output in the U. S. economy was rising one-fifth, the value of total exports rose twice as fast, by 42 per cent. The rise over this period was more rapid for exports than for almost any other major component of demand.

Looking ahead, we expect exports to continue rising more rapidly than GNP--even though agricultural exports, for reasons to be discussed later, are likely to drift downward from their current extraordinarily high level. Nonagricultural exports are projected to increase even more rapidly over the next seven quarters than they did over the past seven quarters. This should be an important source of support for economic activity as growth in domestic demand slackens over the period ahead.

There are two main forces behind the rapid recent and prospective expansion of exports. One is cyclical--the gathering boom in economic activity abroad. The other is more lasting--the improved competitive position of U. S. goods that has resulted from the exchange rate changes of the past 3 years.

In all major foreign industrial areas--Europe, Japan, and Canada--as in this country, the projected growth of output this year is well above long-run average rates. For 1974, the rate of growth of U. S. output is projected to diminish sharply. But in foreign countries, in most of which the upswing began later than it did here, expansion is expected to continue vigorously into 1974, though probably with some slowing by the second half of that year.

A longer-run impetus to rapid expansion of U. S. exports results from the substantial depreciation of the U. S. dollar against foreign currencies over the past 3 years. By April of this year, the dollar was roughly 17 per cent cheaper in terms of a weighted average of 16 leading foreign currencies than it had been in early 1970. In May and June, with exchange rates floating, the international value of the dollar has sunk even lower, as a result of doubts about U. S. stabilization policies and political uncertainties. We have assumed, in our projections, that the dollar will recover somewhat in the months ahead and stabilize at around the April-May level.

A very large competitive improvement for U. S. goods has resulted from this steep decline in the international value of the dollar. While the unit values of U. S. exports expressed in terms of U. S. dollars have risen along with domestic prices, the prices of U. S. goods expressed in the main revaluing foreign currencies have actually been reduced. To a German or a Japanese, for example, U. S. goods are now significantly cheaper on average than they were 4 years ago, whereas his home-produced goods have become considerably more expensive owing to domestic inflation.

A special word is needed about U. S. agricultural exports. During the past year the value of our agricultural exports has shot up by 70 per cent, with the quantity up by one-third and dollar prices up by one-fourth. The surge in foreign demand for these U. S. products has reflected crop shortfalls abroad as well as generally buoyant income conditions. As foreign crops improve, we expect that the volume and value of our agricultural exports will decline somewhat. The proposed export controls on grains and feeds, if adopted, may reduce shipments still further. On the other hand, our guesses about future agricultural export prices may well be too low; export unit values presently lag far behind current market prices.

The export shares of total U. S. supply of four key commodities--soybeans, wheat, corn, and cotton--which together comprise more than half of our agricultural exports, were estimated in the absence of export controls to remain a good deal larger in the coming crop year, 1973-74, than they were only 2 and 3 years ago. Thus, exports are likely to be a major factor keeping domestic prices of these products at high levels.

Nonagricultural exports, as noted earlier, are expected to continue rising rapidly. Prospects are particularly bright for exports of machinery. Both new export orders and order backlogs for machinery have risen sharply in recent months. Just to give you an indication of the orders of magnitude involved here, I might note that U. S. exports of capital goods, other than motor vehicles, now equal about one-fourth of domestic output of such goods, and the ratio is still rising.

Turning next to the import side of our international trade, it should be remembered that currency depreciation affects imports as well as exports only with a lag. We have recently experienced a considerable increase in import unit values. Much of this, however, reflects the unprecedented recent boom in raw material prices, and the general inflation abroad. Only a part of this year's depreciation of the dollar seems to have been reflected so far in rising import unit values. Some further rise in import prices as a result of devaluation probably still lies ahead.

On the other hand, the volume of imports is clearly beginning to be held down in reaction to the relative price increases that have already occurred. Further sizable effects on the volume of imports are expected as the lagged responses work themselves out. Although the value of fuel imports will continue to rise rapidly, we project a marked leveling off in the total value of imports during the period ahead, reflecting both the cumulating effects of the devaluations of the dollar and the slowing in the U. S. economic expansion. Imports in April were below the first-quarter average, and customs receipts for May suggest little change in that month. The ratio of imports to GNP is projected to flatten out in 1973 and 1974 after the rapid rise that began in the mid-1960's.

To summarize the net effect of everything I have so far said, we are projecting a further substantial improvement in the foreign trade balance. By 1974, if not sooner, we should be consistently experiencing a trade surplus for the first time since 1970. That surplus should continue to increase after 1974, provided we do not allow inflation to dull our new competitive edge.

As for the remainder of the balance of payments, we expect much less net change in all the non-trade components of our international transactions than we are projecting for merchandise trade. For example, net investment income is not expected to change much, because the rise in dividend receipts seems likely to be offset by rising interest payments on our recently enlarged debts. Hence, in both 1973 and 1974, the balance on goods and services and the current account balance are expected to improve roughly in line with the improvement on merchandise trade.

The net flow of long-term private capital may revert in 1973 to a more normal net outflow, after the exceptional balanced position last year. Still, all the changes in current-account and long-term capital transactions combined should result in a significant improvement this year in the basic balance--to a deficit of perhaps some $5 billion from the $9 billion experienced in both 1971 and 1972. We are not presenting a projection of capital flows or of the basic balance for 1974 because of the many uncertainties about capital controls here and abroad and about the policies that governments may follow in intervening in foreign exchange markets.

To sum up, the prospects for fundamental adjustment in the U. S. international payments position seem considerably better to us now than they have been for some time. Even under optimistic assumptions, however, it is probably a matter of years--not months--before the fundamental adjustment will have gone far enough to restore a fully satisfactory balance. Moreover, as has been emphasized by the experience of the most recent weeks, we cannot plausibly hope for settled conditions in exchange markets and sustained strength in the international value of the dollar until uncertainties about economic policies and political stability have been fairly decisively cleared away.

Mr. Partee made the following concluding remarks:

Our analysis portrays an economy whose upward momentum is weakening progressively but whose real growth nevertheless remains positive for a protracted period. The expansion in nominal GNP is expected to moderate from more than a $40 billion rate in the first quarter of this year to around $20 billion per quarter in the latter half of 1974. Real growth is expected to slow even more precipitously, from a rate ranging from 6 to 8 per cent or more in recent quarters down to the neighborhood of 1 per cent in the latter part of 1974.

What are the chances that such an extended period of slow and declining rates of expansion could actually evolve? There are obviously many pitfalls. Inventory investment could first be stronger and then weaker than we anticipate. A new major boom in capacity expansion could develop, or capital spending could be cut short more abruptly than we expect by business uncertainties and flagging end-product markets. Consumer demand, buffeted by shifts in the winds of inflation, might now be buoyed by even stronger precautionary buying, or alternatively, it might be reduced by defense of family budgets beyond the dimensions now foreseen. But there is precedent for a lengthy period of slow economic growth. There was very little real expansion throughout 1956 and 1957, a period with similarities to the present.

Another unhappy feature of our projection is the continuation of substantial cost and price inflation. The fixed-weight price deflator is expected to be rising at a 4-1/2 per cent rate throughout the projection period. This expectation could be modified somewhat by the Phase IV program, of course, but the underlying problem is both pervasive and stubborn. We believe that rates of compensation will be under upward pressure, in reflection of past and present increases in the cost of living and of relatively tight markets for experienced and skilled labor, while productivity gains will be slowing in tandem with slower economic growth. The resulting rise in unit labor costs, while it may be offset to some extent by a moderation in the food price rise, seems very likely to be passed through to the over-all price indexes. Here the precedent is much fresher--that of 1969 through mid-1971.

If prices do continue to move strongly upward, even slow growth in real output would involve a considerable continuing rise in the dollar value of GNP. Over the six quarters of the projection, nominal GNP is expected to expand at an average annual rate of slightly over 7 per cent. This is of significance to financial markets, because it is the rise in nominal spending that must be financed through monetary and credit expansion. Our flow of funds projection, developed to be consistent with the level and pattern of GNP foreseen, indicates a moderation in the total of funds raised to annual rates averaging around $160 billion. This is a good deal less than the credit expansion that has occurred over the past year, but it would still represent over 11 per cent of GNP--a relatively high ratio.

The principal sources of the expected moderation in funds raised are the sharp decline in the Federal deficit and a marked reduction in net new borrowing by households--both on home mortgages and consumer credit. But business demands for external finance are expected to remain very large, dropping back by only $6 - $7 billion from the spectacularly high rate in the first half of 1973. For nonfinancial corporations, increasing investment in fixed capital and, for a time, in inventories is projected to outpace the growth in internal funds--retained earnings and depreciation--so that needs for external financing are likely to persist at advanced levels. Much of the borrowing in the first half of 1973 has been at short term--mainly from the banks--but we anticipate that higher short-term interest rates and the desire to maintain reasonably balanced debt structures will lead to more long-term financing in the period ahead.

Higher interest rates are suggested also by the behavior of the income velocity of money. The relation between our GNP projection and the 5-1/4 per cent M_1 growth rate assumption implies a substantial further increase in money turnover through the remainder of this year, before a leveling off occurs in 1974. The share of direct market financing done by households will need to rise, given institutional credit flows and projected financing needs. The increase in this share also suggests further tightness in credit markets, though the indicated tightening appears a good deal less extreme than in 1969.

Based on these calculations, the results of our econometric model and our judgmental evaluation, we believe that the rise in interest rates still has some distance to go. We would expect the 3-month bill rate to rise above 7-1/2 per cent by around year-end, and long-term rates--represented by new high-grade utility issues--to rise more gradually, but by 100 basis points or so, into an 8-1/2 per cent range by the spring of 1974.

The increase projected in long-term rates may seem inordinately large, but it is moderate by comparison with the past relationship of long- and short-term rates. Our model can be used to project long-term rates, taking as given the level of short rates and the actual pace of inflation. Over the past 15 years, the model's forecasting record has been very good, and it would project the long-term rate as rising to about 9 per cent before leveling out next year.

Market rate increases of the magnitude we expect would imply a substantial reduction in the flow of deposits to the savings institutions. We do expect a slackening in institutional savings flows, but inflows seem likely to remain significantly stronger than in 1969 and early 1970. If this is so, and taking into account the increased availability of Federal agency financing, the tightening in mortgage credit availability should be much less extreme than in 1969. But I must emphasize that these projections of deposit growth assume a prompt increase in interest rate ceilings, by one-half of a percentage point across the board for all institutions.

As we see it, then, the prospect is that the kind of constrictions in credit availability that developed in 1966 and again in 1969 can be avoided in the current tight money period. This, basically, is because we assume continued moderate growth in the money supply and continued access to financing by banks and other institutions, at a price, which would permit the accommodation of most credit needs through traditional channels. But the question remains as to whether monetary policy should permit as much restraint to develop as is assumed in the staff projections. We anticipate that real economic growth next year will lag increasingly relative to potential, with the unemployment rate projected to be moving gradually upward to about 5-1/2 per cent by the fourth quarter of 1974.

Given the unsatisfactory state of affairs being projected, we experimented with our quarterly model in an effort to find a monetary policy strategy that would produce better results. The main constraint that we imposed on our simulations was that the unemployment rate not be permitted to rise above 5 per cent at the end of 1974.

Three variants to the standard projection, which assumes adherence to a 5-1/4 per cent growth path for M_1 throughout 1974, were simulated. The first holds money growth on a 5-1/4 per cent path until the end of 1973, and then moves to an 8 per cent growth rate. This is indicated to be necessary if the unemployment rate is to be kept from rising above 5 per cent by the latter part of 1974. The second variant restricts money growth to a 4 per cent path for the remainder of 1973, and then compensates by increasing targeted growth to 10 per cent in 1974. And the third raises money growth to a 6-1/2 per cent path from here on out, in which case no further change in policy would be needed in 1974 to hold unemployment at 5 per cent. The three alternative policy strategies produce similar results in terms of the expected inflation rate, though all show somewhat larger price increases than does the "growth recession" model that constitutes our standard projection.

This is a very long time to look ahead, of course, and economic conditions may well develop differently than we have projected. But the exercise has relevance, I believe, to the Committee's task today of reviewing its longer-term monetary growth targets. If the Committee decides to renew its present 5-1/4 per cent growth path target for M_1, it should do so in recognition of the probable need to ease policy promptly as soon as the economy shows convincing evidence of moderation in the growth of real demand. We believe that this will have occurred, at the latest, by year-end. If the Committee decides to tighten up further at this time, in response to the urgent need now for a greater measure of economic stability, a larger move toward ease is likely to be required later on, again in very timely and even bolder fashion. And should it decide to adopt a somewhat more liberal target for money growth, there may be little need to ease further later on.

Although the 6-1/2 per cent money growth path produces a somewhat smoother and less precarious economic result, according to the model simulations, I believe that such an easing at this time could risk an exacerbation of inflationary fears. The danger is particularly acute now, since market observers will be looking carefully for any signs of easing as an accommodation to the temporary price freeze. My preference, therefore, is for adherence to the 5-1/4 per cent growth path, with a prompt move toward ease as soon as this is indicated by the performance of the economy. Since our current estimate is that the June money stock will be above target, moving back onto the indicated path will require that actual money growth be somewhat below a 5-1/4 per cent growth rate in the months immediately ahead.

Chairman Burns observed that he had looked forward to welcoming Mr. Holland on behalf of the Committee and he wanted to express his special pleasure at having Mr. Holland join the Committee as a member.

The Chairman then invited the members to raise any questions they had regarding the staff's presentation of the economic outlook and, if they wished, to express their own views.

Mr. Brimmer indicated that he did not take issue with the staff projection, but he had a question stemming from the fact that even a small shortfall from the projected slowdown in the pace of economic expansion would mean an actual decline in real economic activity. He wondered what the staff saw in the economic process that would prevent the expected slowdown from turning into a cumulative decline and thus into a classic type of recession.

In response, Mr. Partee observed that the staff had thought long and hard about that question. In the face of the marked slowdown in real demand that was projected, it was a natural inclination to expect the economy to go into a recession, and indeed it was almost a matter of definition whether one counted the minimal real growth anticipated as a recession or not. Over the projection period the continuing, although moderating, investment boom was the major element that prevented real GNP from actually turning down. There was, to be sure, a degree of uncertainty about the projection for business fixed investment; spending programs could be weaker than was anticipated but they might also be stronger in light of an obvious need for additional capacity in a number of basic industries. A second factor supporting the expansion was the prospect of considerable improvement in net exports, especially for nonagricultural goods. In addition, the projection was based on an assumption of moderate growth in the money stock, in contrast with very little monetary growth in the second half of 1966 and in the second half of 1969; the sort of constriction in credit that occurred in those periods and brought about sharp declines in residential construction was not expected to occur in the period ahead.

Mr. Gramley added that the relatively mild decline projected for inventory investment next year from a peak in the fourth quarter of this year was another factor tending to work against a cumulative decline in real output. Typically, in postwar recessions, with the exception of the one in 1969-70, a shift from accumulation to decumulation of business inventories contributed to a cumulative decline in activity. As noted in the staff presentation, the extremely low ratio of inventories to sales in the current period suggested that inventory demand would remain relatively strong next year.

Mr. Brimmer observed that the simulation results of the three monetary policy strategies--which Mr. Partee had described as alternatives to the maintenance of a 5-1/4 per cent rate of growth in M_1 throughout the second half of 1973 and 1974--did not differ significantly from one another in terms of real growth, prices, and unemployment in that period. He asked whether that outcome was due to some properties of the model, such as the time lags. The results appeared to say that the Committee really could not do much to influence the economy in that period.

Mr. Partee said the staff had imposed constraints on the model in arriving at the alternative policy strategies. Specifically, because the standard projection had resulted in an unacceptable rise in the unemployment rate, the model had been run to produce an unemployment rate limited to a maximum of 5 per cent during the projection period. On the other hand, inflationary pressures were already so substantial as to make unrealistic the assumption of a policy strategy designed to reduce the unemployment rate as low as 4-1/2 per cent, so there were constraints on movements in the unemployment rate in both directions. With respect to the GNP deflator, the alternatives did not generate significantly different results because monetary policy affected prices only with a considerable lag and because much of the current inflation reflected cost-push pressures which monetary policy could do little to affect.

Chairman Burns suggested that it was not totally unrealistic to aim at significantly lower or higher unemployment rates for short periods of time than those imposed on the staff's model, even assuming the model's reliability was accepted. He added that he did not agree with the inference that the outcome would be much the same no matter what policy the Committee adopted.

In response to a question by Mr. Coldwell, Mr. Partee said it might be possible, prior to the Committee's discussion of monetary policy, to rerun the model with assumptions that allowed it to generate unemployment rates both higher and lower than the 4-1/2 to 5 per cent range.

Chairman Burns referred to the staff projection of little growth in real economic activity during the second half of 1974 and observed that small deviations from the projection could result in a more favorable economic situation or in negative rates of growth. He inquired whether the model would generate negative growth rates in real GNP if the projection period were extended another six months.

Mr. Gramley observed that the staff projection was judgmental in nature and that it made use of the econometric model only as one input to the staff's analysis. He was not sure how the staff would view the outlook for the first half of 1975 at this point, but it was his impression that the model itself would continue to generate positive growth rates for real economic activity during that period.

Mr. Pierce added that the staff judgmental projection and the pure model exercise produced relatively close results in terms of the behavior of real GNP through 1974. He indicated that the model itself had been run through the third quarter of 1975 and that rates of growth in real activity had remained just barely positive.

Mr. Black suggested that the staff might be underestimating the outlook for economic activity in the first half of 1974. First, as the economic expansion moderated, it seemed to him likely that there would be pressure to ease fiscal policy and perhaps even pressure for a tax reduction. Second, the staff was projecting growth in consumer expenditures in the first and second quarters of 1974 at about the same rate as in the last two quarters of this year. In light of the overwithholding of income taxes this year and what he perceived to be a change in the quarterly pattern of consumer spending, he thought that such spending might be understated for the first half of 1974.

Mr. Partee agreed that a marked slowing in the economic expansion might well lead to measures of fiscal stimulus, particularly in an election year. As he had noted, the staff had incorporated some additional Federal spending in its projection. It had assumed a 10 per cent increase in social security benefits in mid-1974 and somewhat greater unemployment expenditures than were currently budgeted. As to Mr. Black's second point, he felt that tax refunds had an important impact on consumer spending. With regard to the outlook for next spring, however, there were some qualifications he would keep in mind. The staff projection indicated that growth in normally generated personal income would slow materially as 1974 progressed. There would be less overtime associated with a smaller rise in industrial production and jobs would be less readily available, with pockets of unemployment developing. In such an environment he believed consumers would be very cautious about spending lump sum payments such as tax refunds.

Chairman Burns suggested that the staff might be under-estimating the prospective expansion in capital outlays. He inquired whether there was much evidence to support the staff projection that growth in such outlays would moderate.

Mr. Partee replied that further substantial growth in business fixed investment was anticipated in 1973, and the staff projection of a 17 per cent advance from 1972 to 1973 was considerably above the gain indicated by the latest Commerce survey of planned plant and equipment spending. With respect to the tapering off of the expansion throughout 1974, the staff did not expect the burst of spending for trucks, farm equipment, and other machinery to be sustained, and credit conditions would tend to hold down commercial construction. He agreed, however, that if a new boom in capital spending was getting under way in the steel industry and in other manufacturing industries, high rates of expansion in business fixed investment would persist longer.

Mr. Coldwell commented that the degree of leeway for monetary policy appeared to be very small, given the constraints imposed by inflation prospects on the one hand and the level of unemployment on the other. He doubted that it would be possible to achieve the sort of smooth path for the economy indicated by the staff projection even if the associated objectives for M_1 growth were attained. He was especially concerned that none of the policy alternatives presented by the staff resulted in a rate of inflation below 4.5 per cent by the second half of 1974. He believed a rate of 4.5 per cent or higher would be unacceptable and he suspected that the staff might in fact be underestimating the inflation that would occur on the basis of their policy assumptions. In this context he was very much interested in seeing the results of the model simulation when a higher unemployment rate was permitted than the 5 per cent maximum imposed in earlier simulations.

In response to a question by Mr. Eastburn, Mr. Partee indicated that the impact of the price freeze had not been incorporated into the projection. It would have been very difficult to take account of the freeze since its duration was uncertain and the nature of the subsequent Phase IV program was unknown. As a technical matter, the freeze would have no effect on the June price indexes except perhaps in the sense that expectations of a freeze might have produced larger increases in prices than otherwise would have occurred. Indeed, the staff was inclined to the view that the second-quarter GNP deflator might have been understated in the green book.[1/] The freeze would be felt in the deflator for the third quarter; the staff guessed that, if the

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

freeze remained in effect for the full 60 days, it could reduce the third-quarter advance by about two-thirds. Such an outcome was not assured, however, given the uncertain duration of the freeze and the unknown shape of the Phase IV program. Unless that program was extremely rigorous, one could expect at least a small upsurge in prices once the current freeze was lifted. In sum, the staff suspected that the freeze would lead to a dip in the deflator in the third quarter followed by price rises in the fourth quarter of the current order of magnitude, or perhaps even a little higher, unless a really vigorous Phase IV program was instituted.

Mr. Eastburn said that the staff at the Philadelphia Bank had projected somewhat lower unemployment rates than the Board staff, apparently mainly because of different assumptions about productivity trends. He wondered how the Board staff would assess the probability of a greater decline in productivity, perhaps along the lines of the experience in 1969 and early 1970.

Mr. Zeisel remarked that the Board staff projection of productivity developments appeared to be in line with patterns during past "mini-recessions" as opposed to full-scale recessions. If economic activity moderated more, or for a longer period, than was anticipated, the odds favoring a sustained period of deteriorating productivity gains would grow.

Mr. Partee added that the decline in productivity in 1969 followed a long period of sustained economic advance during which there occurred a buildup of excess labor in many types of industries and occupations. When economic activity slackened, the impact of overstaffing led to actual declines in productivity before businessmen recognized the situation and cut back their work forces. In the current situation, there probably had been a smaller buildup of excess workers, given the relatively brief interval since the previous recession.

Mr. Zeisel said he agreed with that assessment. The staff had noted, for example, that the buildup of white collar workers in relation to the total labor force had been relatively restrained in the current economic expansion. Since less excess staffing probably existed at this time, it seemed likely that the impact of a slowdown in the economic expansion would have a relatively smaller impact on productivity than in 1969.

Mr. Morris expressed the view that the staff had been quite realistic in framing its unemployment and price constraints within a fairly narrow range. He was afraid that if a 6 per cent unemployment rate were to be generated, the consensus between the Administration and the Congress calling for restraint in Federal expenditures might well be destroyed. A 5 per cent unemployment rate might be tolerated for an extended period of time but not a 6 per cent rate.

Chairman Burns agreed that a 6 per cent unemployment rate could well lead to a massive Federal budget deficit and also to a marked easing in monetary policy, thereby laying the foundation for further inflation in the future. To achieve price stability it was necessary to avoid recessions, because it was during recessions that the forces of inflation were released. Accordingly, he agreed that the constraints imposed by the staff in its model simulations were probably realistic. However, he thought it would help the Committee to visualize the implications of alternative policy strategies if the constraints imposed on the model were relaxed.

Mr. Winn asked whether the possibility of a major stimulus to capital expenditures stemming from foreign demand had been built into the projections.

Mr. Gramley indicated that such a possibility had not been incorporated into the model. He added that the staff really had relatively little basis on which to make its capital spending projection beyond the end of this year. Past cyclical experience had been reviewed in great detail, but it provided relatively little guidance for the future. He believed that capital spending could move in either direction; it could weaken abruptly if confidence continued to wane or the boom could be prolonged if very heavy demands should materialize from abroad.

Mr. Mayo commented that monetary policy had to contend with an unusual degree of uncertainty in that the shape of the Phase IV program was currently unknown. He wondered if the staff shared his inclination to assume for now that by 1974 the price situation would be about the same as it would have been had the Phase III program been continued and there had been no price freeze and subsequent Phase IV program.

Mr. Gramley said he did not think current monetary policy should be based on an assumption that the price outlook would be unaffected by the freeze and the new control program, although any program would encounter difficulties because of the outlook for wages and unit labor costs. However, the staff did not know what the Phase IV program would be, and that suggested the desirability of waiting until its outlines emerged in order to appraise its implications for monetary policy.

Mr. Partee said he thought Mr. Mayo's view was rather pessimistic, that a great deal depended on the elements of the Phase IV program. The freeze announced on June 13 related only to prices, and as yet there was no indication of the nature of the program to be applied to wages. Should there be a credible and vigorous program to restrain increases in wage rates, despite the recent rise in consumer price index and despite some labor shortages, the rate of inflation could be lowered significantly. And if the widening of business markups could be halted, or even reversed, the effect on inflation would be considerable. During Phase I and Phase II markups had increased much less than had been projected by the model. Since the introduction of Phase III in January, however, the large gap between projected and actual markups had been closing rapidly.

Chairman Burns observed that the Committee would have to reach its decisions against the background of exceptional uncertainties, but he thought it would be reasonable to assume that Phase IV would be a great deal closer to Phase II than to Phase III. In fact, no other assumption would make sense to him at this juncture. In addition, he thought the Committee should keep in mind the possibility that Government action on prices and wages might be accompanied by actions in other areas, particularly in the area of fiscal policy. The main inference he would draw for monetary policy was that the Committee should give itself more elbowroom than at earlier meetings so that it would be in a position to move vigorously toward greater restraint or to shift toward ease without undue delay. In that connection, a wider than usual range of tolerance for the Federal funds rate, as suggested in the blue book,[1/] could be particularly helpful, and the Committee members might wish to review that suggestion carefully before tomorrow's discussion of monetary policy.

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

Mr. MacLaury inquired how the staff interpreted the statistical evidence on wage developments. He noted that the rate of increase in the index for average hourly earnings had varied over the cycle but that the rate of increase in total compensation per manhour had been fairly steady. During the Phase II period, moreover, average hourly earnings in construction and some other industries and data on contract settlements suggested that the pace of advance had slowed. He wondered whether increases in fringe benefits and social security payments, which affected the compensation data, had offset variations in the pace of advance in wage rates so that no real progress had been made in holding down the rise in wage costs.

In response, Mr. Zeisel remarked that there was less cyclical variation in compensation per manhour than in average hourly earnings in large part because the former included salaries of white collar workers as well as fringe benefits. However, even the compensation statistics suggested some slowing in the rate of wage increases in 1972. He added that contract settlements had a muted effect on the broad wage measures because the settlements in any one year directly affected a relatively small proportion of wage earners.

Mr. Daane asked Mr. Bryant what sort of price expectations were built into the staff's projection of a movement to surplus in the trade balance.

Mr. Bryant indicated that the results of the staff's domestic projection had been used for the assumptions about U.S. prices. The staff believed that the rate of inflation in Europe and Japan would be high and that economic expansion in those countries would be rapid, and would continue to be rapid longer than in the United States.

In response to a further question by Mr. Daane, Mr. Bryant said that if the staff were to assume a worse performance for U.S. prices than was indicated by the domestic projection, the impact would be felt largely in 1974 and 1975 rather than so soon as later this year.

Chairman Burns asked whether the staff was assuming that price performance would be better in the United States than in other major countries and, if so, whether it would be significantly better.

In response, Mrs. Junz indicated that the staff was assuming the performance of U.S. prices in 1973 and most, if not all, of 1974 would be more or less in line with that of other countries. In that period, the impact of changes in exchange rates would far outweigh the marginal effects one could expect from relative changes in U.S. and foreign prices. Changes in price differentials had a lagged impact, as Mr. Bryant had suggested, and according to the staff's model any such changes currently would not materially affect the balance of trade later this year or in the first half of 1974 but would begin to exert significant influence by the end of 1974.

Chairman Burns indicated he was enough of an optimist to assume that the performance of U.S. prices, although poor, would be better than that of the outside world.

Mr. Brimmer inquired whether the staff could evaluate the possible impact of the restrictions on food grain exports recently proposed by the Administration. He suggested that even if legislation failed to pass in the Congress, moral pressure might be brought to bear on exporters and the export of agricultural products would be adversely affected.

Mr. Bryant indicated that staff estimates of the possible impact of the proposed export restrictions were very preliminary. There were a number of factors which worked against each other in this situation. For example, restrictions on exports might result in a further rise in prices to foreigners; if this were to happen, the loss in export volume would be partly offset and there would be a smaller decline, or conceivably even an increase, in value terms. The staff hoped to learn more about the details of the proposed legislation and it did not feel it was in a position to make a precise estimate at this time.

Mr. Black said that the staff at the Richmond Bank had run some simulations on the Board's model. The effort did not produce acceptable results until it was assumed that an effective incomes policy would hold the rise in prices down to a 3-1/2 per cent rate.

It was also assumed that the money stock would expand at a 5-1/4 per cent rate. On those assumptions the model produced a 3.2 per cent rate of growth in real GNP in the first half of 1974 and 2.75 per cent in the second half. Of even greater interest, the unemployment rate continued to drift down and reached a level of 4 per cent in the fourth quarter of 1974. Net exports rose sharply to a $7 billion annual rate by the second half of next year, largely because of a decrease in imports. He wondered how the Board's staff would interpret the results of that model exercise.

Mr. Gramley commented that when a key sector of the model such as wages and prices was immobilized, the results of the simulation became fairly mechanical. A given rate of growth in the nominal money stock translated itself into a given growth in real GNP. He did not think the results had much analytical significance; one just did not know how to interpret them.

Mr. Black said his staff had reached about the same conclusion. He had cited the simulation results to highlight the unfavorable outlook in the absence of an effective incomes policy.

Mr. Eastburn said that in light of the comments made about fiscal policy today, especially regarding the possibility of a substantial deficit, it seemed unrealistic for the staff projection to assume a full employment surplus by the fourth quarter of 1973.

He wondered if the Committee should not have before it the implications of a more likely fiscal policy outcome in fiscal 1974 when it began its monetary policy deliberations tomorrow.

Mr. Partee expressed the view that significant changes in fiscal policy were not likely until the spring and summer of 1974. Any changes then would begin to exert their influence only in the second half of the year. In its policy assumptions the staff had simply extended the fiscal and monetary policies that were already in train. The staff recognized that there could be a policy shift; that it would be likely to come later for fiscal than for monetary policy; and that the shape of the second half of 1974 could be significantly affected through both avenues. He noted that analysts at the Office of Management and Budget had recently completed a budget review for fiscal 1974 and they felt confident about the numbers in that review. The Board staff had raised the spending estimates in a few obvious places, but in light of the success achieved over the past year in holding expenditures to budgeted targets, they had been reluctant to raise them very much. The staff could, of course, incorporate a more expansionary fiscal policy in its model and work out the implications, but he did not think it should suggest in its presentation to the Committee that a heretofore successful budget control policy would prove unsuccessful in the year to come.

Chairman Burns said he understood that the staff's model had been rerun on the basis of alternative assumptions discussed earlier and that the results were now available.

Mr. Partee indicated that Mr. Enzler had rerun the model with the constraint on unemployment relaxed and a 4 per cent growth in money assumed throughout the period to the end of 1974. The model had produced a rising unemployment rate to a level of 6 per cent by the fourth quarter of 1974 and concurrently a diminishing advance in the deflator to a rate of 4.1 per cent in the same quarter. Accordingly, a one percentage point increase in the unemployment rate had been associated with a 0.7 percentage point decline in the rate of increase in prices, relative to the simulation results of the three alternative policy strategies discussed earlier today. Holding the unemployment rate at the 6 per cent level had subsequently led to a further reduction in the rate of inflation in 1975 and to a relatively low rate in 1976. Those results were based on the probably unrealistic assumption that unemployment could remain at 6 per cent for a protracted period.

Mr. Brimmer noted that the staff projection indicated a moderation in total funds raised from the pace in the first half of 1973 and a sizable further rise in both short- and long-term interest rates. Presumably, higher interest rates would lead to some economizing in the use of funds and he supposed the reduced availability of funds would also be allowed to show through in the rates that banks and other lenders actually charged to borrowers. He wondered, however, what would happen if the increase in interest rates were to be dampened somewhat by controls of one sort or another.

Mr. Partee suggested that nonprice rationing could produce much the same effect as higher interest rates in curbing the general availability of credit. In such a situation there could occur some rather massive shifts in the sources of funds such as were experienced in 1969 when the availability of bank credit was restrained. The end result could be less residential construction than the staff had incorporated into its projection but perhaps not much change in business borrowing, since businesses would continue to have access to the markets. In sum, nonprice rationing could have a significant effect on the sectoral flow of funds.

Chairman Burns suggested that Committee members consider the rate of growth in M_1 that they would like to achieve over the next 6 months. He asked for an informal poll regarding the members' preferences for growth over the second half of 1973. In indicating their preferences, individual members might or might not want to take into account the fact that since March growth of M_1 had exceeded the rate desired by the Committee.

In the subsequent poll, preferences were indicated for 6-month growth rates in M_1 ranging from 4-1/2 to 5-1/4 per cent, with the largest number favoring a 4-1/2 per cent rate.

Thereupon the meeting recessed until 9:30 a.m. the following morning, Tuesday, June 19, 1973. Messrs. Mitchell and Sheehan, who had been absent on Monday afternoon, were present. Staff attendance was the same as on Monday afternoon except that Mr. Williams of the San Francisco Reserve Bank and Miss Stockwell, Mrs. Junz, and Messrs. Enzler, Ettin, Gramley, Morisse, Nicoll, Peret, Roxon, Smith, Taylor, Wetzel, Wyss, and Zeisel of the Board's staff were absent and the following persons were present:

Mr. O'Connell, General Counsel

Mr. Reynolds, Associate Economist

Chairman Burns noted that, as indicated in his memorandum dated June 18, 1973, and entitled "Election of Secretary for the FOMC," Mr. Holland had resigned as Secretary of the Committee on June 11, 1973, the day he had entered on duty as a member of the Board of Governors. To succeed Mr. Holland as Secretary, the Chairman recommended that the Committee elect Mr. Broida.

By unanimous vote, Arthur L. Broida was elected Secretary of the Federal Open Market Committee, effective immediately, to serve until the election of his successor at the first meeting of the Committee after February 28, 1974, with the understanding that in the event of the discontinuance of his official connection with the Board of Governors he would cease to have any official connection with the Federal Open Market Committee.

Chairman Burns then suggested that the Committee turn at once to consideration of monetary policy, introducing international developments only to the extent that they had a bearing on the current monetary policy decision. The discussion of foreign currency operations would follow.

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 May 15 through June 13, 1973, and a supplemental report covering the period June 14 through 18, 1973. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Sternlight made the following statement:

> Open market operations since the last meeting of the Committee have been shaped mainly by the effort to slow down excessively rapid growth in the monetary aggregates. Almost from the outset of the period it was estimated that the aggregates were growing at around the upper ends of their ranges of tolerance, and the Account Management accordingly moved quickly to seek conditions of reserve availability consistent with the more restrictive end of the range initially indicated by the Committee--that is, a Federal funds rate around 7-7/8 per cent. In succeeding weeks, estimates of growth in M_1 and M_2 for the May-June period were strengthened further, reaching rates significantly in excess of the ranges set at the May meeting. In response to this strength, the Committee approved two increases in the upper limit of the range of tolerance for the Federal funds rate--to 8-1/4 per cent on May 24 and to 8-1/2 per cent on June 8--and the Desk made use of this added flexibility to achieve firmer money market

conditions. In the past few days, the Desk has been aiming for a degree of restraint on reserve availability that would result in a Federal funds rate around 8-1/2 per cent.

Estimated growth in RPD's remained around the upper end of the range of tolerance for that quantity, but did not rise above it in parallel with M_1 and M_2, as estimates of the multipliers between reserves and monetary aggregates were adjusted during the interval.

Another major circumstance conditioning Desk operations during the recent period has been the sharp seasonal rundown in the Treasury's cash balance. From the week of May 16 through the week of June 13, the average Treasury balance at the Federal Reserve Banks fell by about $3 billion--releasing an equivalent amount of reserves. To offset this huge release, the Desk employed a combination of means, including outright sales of bills in the market and to foreign accounts, substantial redemptions of bills in Treasury auctions, redemption of repurchase agreements that were on the books in the mid-May period, and large-scale matched sale-purchase transactions in the mid-June period.

Reflecting higher day-to-day money costs and increased supplies of Treasury bills that were partly due to System sales and redemptions, bill rates and other short-term rates have moved sharply higher during the period since the last meeting. The day before the last Committee meeting, 3- and 6-month Treasury bills were auctioned at average rates of about 6.18 and 6.46 per cent, respectively. Yesterday, the average rates were both about 7.26 per cent--up 108 and 80 basis points, respectively, in the 5 weeks. Other short-term rates also recorded steep increases. Thus, 90-day dealer-placed commercial paper is up about 7/8 of a percentage point to 8 per cent and bankers' acceptances are up a similar amount. Major banks have raised their 3-month CD rates from around 7-3/8 per cent to more than 8 per cent. Banks have also raised their prime rate on loans to large business borrowers in two steps of 1/4 point each, to 7-1/2 per cent, and yesterday it appeared that a third 1/4 point rise was being initiated.

The sharp rate increases have been concentrated in the short-term area. Rates on intermediate-term issues have shown little change and in the case of 3- to 5-year Treasury issues rates are now lower than

5 weeks ago. Long-term rates have risen relatively moderately--on the general order of 1/8 percentage point or so for Treasury issues and seasoned corporates, but somewhat more for new corporate debt issues. A notable area of steady rates is the market for intermediate-term Federal agency issues, where bank and other demand for maturities in about the 3- to 5-year range has enabled the agencies to meet their large cash needs without great difficulty.

Underlying the relative insulation of the intermediate- and longer-term markets from the intensified pressure in the short-term money market is the widespread feeling that current money market pressures will prove to be short-lived. Many participants in the financial markets expect a peak in short rates within the next 3 months. Hence there is a willingness by banks to pay over 8 per cent for 3-month CD's, but typically less for somewhat longer CD's. And at the same time banks and other investors have been willing to purchase intermediate-term agency issues at yields not much over 7 per cent. The prevalence of this attitude raises some question about prospects for slowing down growth in the money and credit aggregates.

For the period ahead, the alternatives set out in the blue book suggest a wider than usual band of tolerance for the Federal funds rate. If this approach is adopted, the Account Management would appreciate having as much guidance as possible from the Committee in using the wider band. Based on past practice we would be prepared to respond to evidence that aggregate measures were turning out toward the higher or lower side of their desired ranges by encouraging conditions of reserve availability that also veered toward the appropriate tolerance limits. For example, if the Committee chose alternative B,1/ associated with M_1 growth in the June-July interval of 6 to 8 per cent and a Federal funds range of 7-1/2 to 9-1/2 per cent, and if M_1 were turning out around 7-1/2 per cent, it would seem appropriate to expect Federal funds to be edging up toward 9 per cent. And if M_1 growth for the two months approached 8 per cent then the 9 to 9-1/2 per cent portion of the Federal funds range would presumably be used. Similarly, we would tend toward the lower part of the Federal funds range if the aggregates came in toward the weaker side of their ranges.

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

Market reactions to adjustments in conditions of reserve availability probably will continue to depend on expectations of market participants. If money market conditions tighten further because of continued strength in the aggregates, short-term rates are likely to push higher, but the impact on intermediate- and longer-term markets may continue to be tempered by the view that pressures will soon subside. If the view took hold that pressures might last quite a while longer then the intermediate- and longer-term markets could worsen dramatically.

On the other side, if incoming data on the aggregates induced the Desk to foster somewhat easier day-to-day conditions of reserve availability, this could lead to a rapid spreading of the view that the corner had been turned on interest rates. In turn, this could produce a sharp rise in note and bond prices as investors scrambled to avoid being left behind by a major rally.

A factor to keep in mind about the period ahead is the likelihood that as the Treasury rebuilds its balance in the Reserve Banks, there will be a massive need for the Desk to offset the resulting reserve absorption through large-scale purchases of securities. We would expect to divide this task among outright purchases of Treasury bills, of Treasury coupon issues, and of Federal agency securities and at times substantial use of repurchase agreements. Depending on how high the Treasury wants to build its Federal Reserve Bank balance, and on the effect of other reserve factors, there may possibly be a need to request temporary enlargement of the Committee's standard inter-meeting leeway for changes in the System Account holdings of securities, but I would not see the need to recommend immediate action.

I would also like to alert the Committee to the possibility that special actions may have to be considered later this month in the event that Congress delays action on the debt ceiling. You may recall that contingency plans were developed to cope with this possibility a year ago. We are now re-examining those plans.1/

Finally, I note with regret that one of the newer Government dealer firms--Paine Webber Jackson & Curtis--has decided to suspend its Government dealer operations, thus cutting our number of dealers back to 24. They found the dealership unprofitable, and given all the

1/ Subsequent to this meeting new contingency plans to deal with the possibility described by Mr. Sternlight were developed. A description of those plans, which were approved by Committee members on June 29, 1973, is appended to this memorandum as Attachment B.

other difficulties of stock market operations these days the firm chose not to continue carrying the dealership function.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 15 through June 18, 1973, were approved, ratified, and confirmed.

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

The price freeze and the uncertainties as to the precise character of Phase IV suggest that monetary policy over the near term might consider a holding action, but a holding action with certain special attributes. I would suggest three attributes for a near-term policy strategy under current circumstances.

First, in view of the substantial overshoot in the monetary aggregates during the second quarter, a firm upper limit might be placed on growth in the aggregates in the period ahead. The upper limits of the June-July ranges for alternative B are one reasonable alternative. This upper limit is 8 per cent for M_1. Over the longer run, one would aim at a considerably lower growth rate, of course. The blue book explains that staying on a 5-1/4 per cent long-run path measured by M_1 requires a 4-1/2 per cent rate of growth in the second half of the year to make up for the second-quarter overshoot, provided of course that our current June estimate is accurate. If that estimate is accurate, the rapid growth already in train for the month appears to make it difficult to aim at sharply curtailed growth over the 2-month June-July period. For July alone, though, M_1 growth of around 5 per cent does seem feasible and would, if achieved, represent a solid step toward attainment of the long-run growth path.

A second attribute of near-term strategy would be to permit shortfalls in the aggregates from the June-July ranges suggested in the blue book. This would permit more rapid movement back to the long-run path. It would also allow for the very real possibility that there will be a near-term downward shift in the demand for money for the simple reason that, with prices frozen, less cash will be required for a given amount of transactions. History seldom repeats itself exactly, but it should be pointed out that in the first 7 months of 1971--before the August freeze--M_1 expanded at almost a 10 per cent annual rate. By contrast, in the August-November period encompassing the freeze, M_1 rose at less than a 2 per cent annual rate.

Third, while there is good reason to permit a very slow growth in M_1 over the near term, the Committee may still wish to guard against the development of conditions leading to undue retardation of growth over the long run. There are special circumstances in the current situation which make that at least a little more than a remote possibility. If the public comes to believe that the price freeze will be followed by an effective Phase IV, it is likely that interest rates will tend to decline as inflationary expectations lessen. This could manifest itself in the short run by a shift out of cash into market instruments. Should such a movement develop, it would probably be desirable not only to accommodate the slow growth in M_1 but also to permit some decline in interest rates, including the Federal funds rate.

The funds rate would tend to decline if the whole interest rate structure shifted downwards. Fighting such a decline by absorbing reserves would depress the aggregates even more and would forestall as much overall interest rate decline as was consistent with the changed economic outlook. Thus, the impact of such a policy, if sustained, would be more deflationary than desired.

At the moment, of course, the prospects of declining interest rates are hardly in the forefront. Yesterday's staff presentation pointed to higher interest rates over the balance of the year. And while market thinking tends to be less bearish on debt instruments, most market participants would, I judge, place any turn to declining interest rates some months ahead.

Nevertheless, in a volatile and uncertain economic situation--and with market attitudes toward interest rates subject to rapid change--I believe it is sound to begin to broaden out the permissible range of money market fluctuation. If the economy should prove stronger than anticipated, this would provide resistance to a strengthening of credit and money demand. On the other hand, should inflationary expectations abate and/or the economy weaken unexpectedly, interest rates could begin to move down promptly, as would then be required if the Committee were successfully to provide the total reserves needed to sustain growth in the aggregates on the desired path.

Mr. Daane noted that in the blue book the staff had taken as a base or starting point for three alternative monetary growth paths the average level of M_1 in June that would be consistent with the midpoint of the 5 to 5-1/2 per cent growth rate that the Committee had adopted in March. In other words, the starting point was the level that M_1 would have attained in June if the longer-run target adopted at the March meeting had been realized, and from that point three alternative growth paths had been projected for the second half of the year. Because M_1 in June was proving to be above the level consistent with the target adopted by the Committee in March, the actual rate of growth from June through the second half of the year would be adjusted downward for each of the three alternatives presented. In his view, there were difficulties in translating the desired longer-run rate of growth in M_1 into actual rates for the months ahead and then relating them to what could actually be achieved by open market operations.

Continuing, Mr. Daane said he did not see how at this time one could choose an optimal rate of growth for M_1 for the next 6 months and use that as a guide to the specifications and operations for the period until the next meeting of the Committee. In view of the fact that the dollar was under attack in the foreign exchange markets, and given the current state of market expectations as described by Mr. Sternlight, it seemed to him that the procedure of spelling out specifications in terms of desired rates of growth in the monetary aggregates over a 6-month period would not produce the kind of policy needed at the moment. For both domestic and international reasons, he favored a policy as tight as possible without disrupting the financial markets, and he would ask what sort of specifications would achieve that policy.

Chairman Burns expressed the view that Mr. Daane's question could be answered only in terms of interest rates.

Mr. Daane indicated that in his judgment it was not useful at this stage to approach the problem of policy by considering different rates of growth in the monetary aggregates.

Chairman Burns remarked that was one point of view, with which other members of the Committee might or might not agree.

Mr. Axilrod said he would comment on the first part of Mr. Daane's remarks by referring to a special chart included in the blue book.[1/] The chart represented an effort to show the actual course of growth in M_1 in relation to the longer-run target the Committee had adopted in March--and had reaffirmed in April and May--and in relation to three possible policy courses for the second half of the year. Thus, the chart showed actual monthly average levels of M_1 starting with September 1972 and ending with the estimate for June 1973. The chart also showed the 5-1/4 per cent rate of growth for the second and third quarters combined--the longer-run rate of growth adopted by the Committee at the March meeting--projected from the estimate for the March level available at the time of the March meeting. Because the second-quarter rate of growth proved to be much greater than expected, the estimated level for June was considerably above the projected level.

In looking ahead to the second half of the year, Mr. Axilrod observed that one of the three policy courses depicted--and the one recommended yesterday by Mr. Partee--represented an effort to get back on the growth path of an annual rate of 5-1/4 per cent projected from the estimated March level. The other two alternatives represented rates of growth faster and slower than 5-1/4 per cent

1/ A copy of the chart referred to has been appended to this memorandum as Attachment C.

from the level in June that would have been reached if the target adopted in March had been realized. Because of the 8.5 per cent rate of growth of M_1 in the second quarter, a 4-1/2 per cent rate of growth would be required in the second half of the year to get back on the 5-1/4 per cent growth path--although a higher or lower rate would be required if the actual figure for June proved to be lower or higher than estimated at this time.

Continuing, Mr. Axilrod remarked that although the Committee had experienced difficulty in controlling the monetary aggregates over the past 2-1/2 years, it had been reasonably successful considering the state of knowledge. The alternative patterns of monetary developments presented in the blue book were thought to be realistic, and any one could be achieved if the Committee were willing to countenance the associated interest rate developments.

Mr. Daane said that in view of developments in foreign exchange markets and other special circumstances, an effort to move back toward the 5-1/4 per cent longer-run growth path for M_1--by specifying a growth rate of 4-1/2 per cent over the third and fourth quarters combined--might be associated with interest rate developments that differed from those described in the blue book, and he was left with the question of how the Committee could adequately give instructions for the conduct of operations in the period until the next meeting.

Mr. Mitchell referred to Mr. Sternlight's remarks regarding current market expectations that short-term interest rates would soon pass their peak, which had led to low intermediate- and long-term market interest rates relative to short-term rates. He asked about the basis for those expectations and what might happen to them in the event that the Federal funds rate ran up an additional 150 basis points in the next 3 or 4 weeks.

Mr. Sternlight replied that market expectations for a downturn in short-term interest rates within the next 3 months were based mainly on the assessment that economic growth would be slowing down. However, a jump of 150 basis points in the funds rate over a 4-week period, to a level of about 10 per cent, would most likely induce a change in expectations for market rates.

In response to a question by Mr. Daane, Mr. Sternlight added that if the Federal funds rate rose gradually by about 100 basis points to 9-1/2 per cent--which was the top of the range associated with alternative B specifications--he would estimate that it might be on the border line of leading to a broad change in expectations for interest rates in the near term. During the past month, when increases in the funds rate had been sizable compared with earlier experience, market participants had tended to view each increase of 1/4 or 3/8 of a point as merely moving the rate closer to its peak and not as a reason for changing their expectations for a downturn within a fairly short period. In his opinion, a larger and more abrupt increase in the funds rate than 100 basis points spread over a 4-week period would be required to change market expectations.

Mr. MacLaury observed that the interest rate expectations described in the staff presentation on the preceding afternoon--a 3-month bill rate above 7-1/2 per cent by around the year-end and long-term rates, represented by new high-grade utility issues, at about 8-1/2 per cent by the spring of 1974--were higher than his own expectations. He asked whether such levels were much above those expected by market participants and, if so, whether the spreading of such expectations would provoke a rapid adjustment in rates.

In reply, Mr. Sternlight said the bill rate was about 7-1/4 per cent currently, and a number of market participants thought it could well rise to 7-1/2 per cent within a month or two. With respect to the long-term rate, however, the current level was about 100 basis points below the level projected in the presentation, and that much of a rise would come as a surprise in financial markets.

Mr. Partee remarked that Treasury bill rates had risen about 100 basis points since the May meeting of the Committee, and as had often occurred in the past, such a major move in the rate might be followed by stability for a time or even by a technical rally. To a considerable extent, market participants looked for the technical movements and took advantage of short-term swings in rates. Through the summer and autumn, however, investors could well adjust their attitudes about rates upward, as they had in other periods of rising rates.

Mr. Kimbrel noted that alternative B in the blue book specified a Federal funds rate range of 7-1/2 to 9-1/2 per cent until the next meeting of the Committee in association with an annual rate of growth of 6 to 8 per cent in M_1 in the June-July period, which in turn was associated with a 4-1/2 per cent rate of M_1 growth for the third and fourth quarters combined. He asked Mr. Sternlight whether in his view an upper limit of 9-1/2 per cent for the funds rate was high enough to permit realization of those objectives for M_1.

Mr. Sternlight replied that he was uncertain; it might be that the funds rate would not have to rise that high in order to achieve the M_1 target of alternative B in the June-July period. He did believe, however, that the 9-1/2 per cent level represented at this time a borderline of a kind that a movement beyond it could begin to be fairly upsetting to the market.

Mr. Coldwell asked whether a wider range for the funds rate had been proposed in order to allow for the possibility of a down-turn in interest rates in the period before the next meeting.

In response, Mr. Axilrod said that because of the price freeze, the transactions demand for money might grow less rapidly in the period immediately ahead. He assumed that the Committee would wish to accommodate that slowdown and would not wish to bring about a sharp reduction in the funds rate in the process of attempting to maintain growth in M_1. If the price freeze had that effect, it might also--although it seemed unlikely at present--moderate inflationary expectations. In that event, or if economic expansion proved to be weaker than projected, the Committee might wish to accommodate a decline in interest rates as well as a slowdown in growth of M_1. On the other hand, the new moves in the stabilization program might have little effect, and economic expansion might prove to be stronger than expected. Thus, there were good reasons at this time to extend the funds rate range in both directions. More generally, as argued in the staff memorandum reviewing the RPD experiment,[1/] the effective pursuit of a reserve or aggregate target required a wider range for the funds rate.

Mr. Coldwell commented that it was possible to set a funds rate range wide enough to encompass a variety of possible developments, and he asked whether it was better to set a wider range originally or to plan on modifying the range during the intermeeting period if called for by circumstances.

1/ A copy of this memorandum, dated June 8, 1973, and entitled "Review of RPD Experiment," has been placed in the files of the Committee.

Mr. Axilrod replied that that was a matter of the Committee's strategy.

Mr. Bucher noted that the staff explained the high rate of monetary growth in the second quarter mainly in terms of the effects of the large refunds of personal income taxes concentrated in that period and that, therefore, it expected a slowdown in monetary growth in July. However, it seemed that the staff was not quite sure of that explanation. With respect to the effect of the new price freeze on the demand for money, he asked what the experience with the freeze imposed in August 1971 suggested for the current period.

In response, Mr. Axilrod said the projected slowing in monetary growth in July reflected in large part the unwinding of the effects on privately held cash balances assumed to have been engendered by the large tax refunds, but he agreed that there was uncertainty about it. With respect to the freeze, its potential moderating effect on the demand for money was not incorporated in the rates of growth for the June-July period specified in the blue book. If the freeze should have that effect and M_1 appeared to be growing at a rate below the specified range, the Committee might not wish to move as quickly as in other circumstances to maintain the rate of monetary growth. However, low growth for an extended period of time would be a source of concern.

Mr. Partee added that there were profound differences between the current situation and that in August 1971 when the 90-day freeze was imposed on prices and wages. Following that freeze, Treasury bill rates dropped by about 50 basis points within about 10 days, and investors rushed to obtain securities whose yields, in their view, might drop substantially in the near future. Since imposition of the latest freeze, in contrast, bill rates had gone up, and there were no indications that investors were behaving in accordance with a lessening in their inflationary expectations and with anticipations of generally lower interest rates. While there was little similarity between the current situation and that in August 1971, belief in the efficacy of the stabilization program could grow in coming weeks, and a decline in interest rates could develop--a decline which ought to be accommodated to some extent.

Chairman Burns then said that the Committee was ready for its general discussion of monetary policy and the directive. He observed that the Committee's deliberations today were of more than ordinary importance because of a number of recent developments. With respect to policy, the System had tightened credit conditions substantially. Reserve requirements had been raised and the discount rate had been increased. Because growth in the monetary aggregates had been in excess of the desired rates, the Committee had consulted twice since the May meeting and had agreed to allow the Federal funds rate to rise well above the upper limit set at that meeting. Apart from its undesired effects on the economy, the excessive rate of monetary growth was a potential source of embarrassment to the System. Some participants in financial markets already were speculating that the System would relax its policy of restraint on the grounds that the new price freeze and Phase IV to follow would manage the problem of inflation. That interpretation of policy was very unfortunate, but it needed to be taken into consideration.

The Chairman observed that in view of developments in the real economy, of the potential effects of the price freeze, and of the rapid monetary growth, the basic question before the Committee was whether it wished to restrain growth in the monetary aggregates and was willing to tolerate the inevitable rise in interest rates. Should the members decide, as he believed they should, to take further measures to restrain growth in the aggregates, they should also be especially alert to changes in underlying conditions and they should be prepared to reverse course more quickly than the System had at times in the past. A widening of the range for the Federal funds rate, as suggested in the blue book, would help to prepare for an eventual turn-around in policy and it would facilitate a move in that direction when it seemed desirable.

Mr. Brimmer remarked that before turning to the issues he wished to comment on some criticism that had been made of the blue book analysis of the policy alternatives, which was organized around a special chart portraying different M_1 growth rates starting with the desired, rather than the actual, level in June. He believed that the staff had developed the chart in response to questions that had arisen at a briefing of the Board and that the staff had tried to be helpful.

Chairman Burns commented that he did not think anyone intended to criticize the staff; obviously it had tried to help the Committee. However, his long experience as a teacher suggested to him that in the effort to explain to the Committee the alternative courses for the monetary aggregates, the staff would have done better to use fewer numbers.

Mr. Brimmer then said he agreed with both the Chairman's description of the issue before the Committee and his conclusion for the direction of policy. However, he thought it was not sufficient that market interest rates move up from recent levels; it was also important that the central bank and the commercial banks pass on the increases in rates to final borrowers. Like the Manager, he believed that market participants expected that short-term interest rates would soon peak. With that expectation, borrowers would not hesitate to pay high short-term rates to finance spending in an economy that was faced with substantial pressures on capacity. Therefore, it was necessary that potential borrowers be faced with higher interest rates at commercial banks, which had a bearing on the posture of the Committee on Interest and Dividends as well as on that of the FOMC.

With respect to policy, Mr. Brimmer continued, he would not expect to make much progress in the June-July period toward the degree of moderation in monetary growth that he would like to see over the rest of the year; the lags between Committee actions and their effects were too long. Therefore, he would not try to slow monetary growth very quickly and provoke a rapid run-up in interest rates. However, he would want to be firm and clear about the direction of interest rates, and he would want the increases to spread through the whole spectrum so that ultimate borrowers would have to pay higher rates and, hopefully, would cut down on the amounts that they tried to borrow. Using M_1 as an indicator of all the aggregates, the target for the second half of the year should be closer to an annual rate of 4-1/2 or 4 per cent than to 5-1/2 per cent.

Mr. Brimmer said the range for the funds rate needed to be widened and the Manager had to be free to move somewhat more quickly; he advocated not only a wider range but also more movement of the rate within the range. The Committee had raised the upper end of the range in the period since the last meeting, but a wider range to begin with would have helped in the planning and execution of operations in the inter-meeting period. In considering the range, the Committee ought to take into account that the Board had suspended the remaining Regulation Q ceilings on large-denomination CD's and had introduced marginal reserve requirements on the large CD's, thus placing greater reliance on the price mechanism to ration credit. That implied to him that higher interest rates would be required to achieve a given effect on required reserves than would have been the case with the Regulation Q ceilings in place.

In response to a question from the Chairman, Mr. Brimmer said he thought--and the Dallas Bank report entitled "Aggressive Bank Contacts"[1/] had confirmed his view--that the two-tier system for the prime rate had relieved some of the pressure on banks by enabling them to charge higher rates to their big borrowers; however, consumers and other small borrowers also were demanding loans, and it did not appear that they were being priced out of the market. He inquired whether the Committee on Interest and Dividends was in a position to permit more flexibility in rates.

1/ A copy of this report, dated June 13, 1973, has been placed in the files of the Committee.

In response, Chairman Burns said the CID would not change the two-tier system in the near future. It had been designed to enable banks to function rather freely, and the prime rate for large businesses was now virtually a free rate. On the preceding day, one large bank had raised the prime rate to 7-3/4 per cent and there had been some press reports to the effect that "sources" expressed dismay, but there was no foundation for those reports. Although the large-business prime rate was moving up a little more slowly than some banks would like, interference by the CID was negligible.

In his judgment, the Chairman said, the two-tier system had no effect on small- or intermediate-size banks, and it had an effect on the very large banks only to the extent that a small fraction of their total loans was composed of loans to consumers, farmers, and small businesses. Altogether, the two-tier system had a negligible economic effect. However, it had been of incalculable value in de-politicizing interest rates rather effectively.

Mr. Coldwell asked whether the CID had received requests for an increase in the small-business prime rate.

Mr. Brimmer, noting that he had had the same question in mind, commented that officers of some small- and medium-size banks engaged in lending to small- and medium-size businesses had indicated to him their impression that they could not raise their rates. In the past, they had frequently tied rates on such loans to the prime rate, but they felt that CID guidelines now prevented them from doing so.

In response, Chairman Burns observed that small banks had long operated with traditional interest rates and that the amplitude of movements in their rates had been very much smaller than in rates charged by money market banks. Rates might be held down on some loans here and there, but the importance of that development was not great. As far as he was aware, therefore, that was not a problem for the CID.

Mr. Axilrod remarked that from January through May, interest rates on small loans--which might be taken to reflect loans to small business--had gone up by about 40 basis points.

Mr. Brimmer noted that the officers he had mentioned of small- and medium-size banks had pointed out that they were lending in amounts of $100,000 to $500,000 to medium-size businesses. He did not believe that such loans were reflected in the statistical series to which Mr. Axilrod had referred.

Mr. Mitchell observed that the public's great anxiety about inflation and its demand for action was entirely understandable.

The politicians' desire for action also was understandable, since they had to live in the light of the way they satisfied the public's demands. He was not so sure, however, that the Committee--except for its visible public posture--ought to become that alarmed about the inflation problem. The members could debate for a long time whether the "nearly runaway inflation," as it had been described in the staff presentation on the preceding afternoon, was a product mainly of agricultural and export policies or, as Homer Jones had recently said, was a product of excessively fast growth in M_1. In his view, it was due more to the former than to the latter. In either case, however, Committee members needed to remember that policy decisions taken today would have much of their effect quite some time later and the consequences would be evident in a major way toward the end of 1974.

Continuing, Mr. Mitchell remarked that in the presentation yesterday afternoon--which he had heard was splendid--the staff had postulated growth in M_1 through the second half of 1973 and in 1974 at an annual rate of 5-1/4 per cent, about the same as the rate of growth in the first half of this year, and the staff had projected a steady weakening in the economy through the rest of this year and into 1974. That had been the result even though, he was sure, the model could not reflect the current despair in the stock market, the effect on public confidence of the international speculation against the dollar, or the extensive public apprehension about future trends in prices and personal income. The cyclical developments being witnessed currently were phasing into a recession in growth; hopefully the situation would not worsen beyond that. However, some economists in private industry were perceptive, and like the Committee's staff, they would forecast the probable decline in consumer demands and, contrary to staff expectations, they would do so in time to warn their principals against excessive accumulation of inventories. They might well also counsel moderation in expansion of plant, if indeed the economic environment was not already ominous enough to compel their principals to scale down their planned expenditures.

Mr. Mitchell said the implication of his line of thought was for little change in the Committee's policy; because of the many uncertainties, he was not convinced that further tightening was necessary. If he did wish to tighten further, he would prefer using reserve requirements--an across-the-board increase--to using open market operations because of the former's greater visibility and greater effect. He noted that the staff had attributed the rapid rate of growth in M_1 in the current quarter to the impact on personal balances of the refunds of Federal personal income taxes. His own theory, however, was that the high rate was attributable to the effect on corporate balances of a tightening up of requirements affecting compensating balances. The behavior of M_1 in the third quarter might or might not provide an answer. In any event, long-term interest rates had not yet risen in response to the recent rise in short-term rates, and if they did, the economy would have to absorb that jolt to business investment in plant and equipment. Moreover, as the Dallas Bank report had suggested, many commercial banks were just beginning seriously to reflect the monetary restraint in their lending policies. With respect to the policy alternatives in the blue book, all three, as usual, fell within the range of error in projections of M_1 growth. Semantically, he preferred alternative A, but the attempt to achieve alternative A might result in the pattern of alternative B or C, or in some unspecified pattern.

Mr. Eastburn remarked that the Federal funds rate needed to be more flexible. As had been pointed out in the staff review of the RPD experiment--which he thought was an excellent paper--the Committee had been more successful in reaching its targets for the funds rate than those for the aggregates. Therefore, he would welcome a widening of the range for the funds rate.

Mr. Eastburn--recalling Chairman Burns' comment on the day before that the seeds of inflation were sown during recessions--observed that it was also true that the seeds of recession were sown during periods of inflation. Obviously, it was desirable to arrive at a policy that would help curb further inflation but that would also avoid bringing on a recession. The staff at the Philadelphia Bank had investigated the question of the extent to which the rate of growth in M_1 could be reduced without provoking a recession. Judging from past experience, it appeared that a reduction in the M_1 growth rate of about 1-1/2 percentage points from the average rate over the past year would be permissible with a minimum risk of bringing on a recession. A reduction of as much as 3 percentage points obviously would involve more risk. Although such calculations were crude, he would conclude that a reduction in the longer-run rate of growth in M_1 to around 5 per cent--or a little higher--could be accomplished without a substantial risk of provoking a recession.

The adoption of such a target, Mr. Eastburn continued, would represent a steady objective for policy, which was appropriate for the current phase of the cycle. The Committee could always debate how much it should consciously vary the longer-run rate of growth. At present, the question was whether it should attempt to "fine tune" a reduction in monetary growth and be prepared to change direction promptly or whether it should try to maintain a relatively constant rate of growth. It was not the time for a sharp reduction, despite recent overshoots, because the impact of such a policy would be felt when the economy was weakening in any case. Then, a turnaround would be necessary, and that sort of stop-and-go policy had not been very effective in the past and was unlikely to be so in the future. Therefore, he preferred specifications about midway between those of alternatives A and B.

Mr. Black said he agreed with Mr. Eastburn's observations. Given the behavior of prices, one might be tempted to press down hard on the monetary brakes. Despite the recent bulge in monetary growth, however, the annual rate of growth in M_1 over the first half of the year was well below the rate in the second half of last year--5.4 per cent compared with about 8.5 per cent. A recession often had followed such a slowing down in the rate of monetary growth, although there was doubt about causation. Like Mr. Eastburn, therefore, he would aim for a rate of growth in M_1 of about 5 per cent. However, he would accept a slower rate of monetary growth if evidence developed that the demand for money was shifting downward, as the blue book suggested it might.

The main concern for the next few weeks, Mr. Black continued, was to avoid a credit crunch. Commercial banks were in a tight position and were being subjected to pressures to reduce their lending. The banks that he had contacted had been cutting back on their new commitments and their extension of loans under existing commitments, even when valued customers were involved. Much further rise in money market rates, therefore, might provoke a scramble for funds that would be accompanied by a substantial rise in short-term interest rates generally and perhaps also a sharp increase in long-term rates.

Mr. Black said he favored a widening of the range for the Federal funds rate. Steady interest rates were not compatible with a steady rate of growth in the money supply, and he would prefer steadier monetary growth. At present, however, he had serious reservations about allowing the funds rate to go as high as 9-1/2 per cent; he was inclined to put the ceiling at 9 per cent. To avoid the possibility of misleading the market, he would not allow the funds rate to fall below 7-3/4 per cent. He preferred the language of alternative B and specifications shaded a little toward those of alternative A.

Mr. Francis observed that although the System had taken firming actions recently, monetary expansion had remained rapid, and the Committee needed to restrain monetary growth. As others had remarked, experience indicated that sharp changes in the average rate of monetary expansion could cause real problems. Therefore, he would like to see the rate reduced more gradually than it generally had been in the past. The staff estimate of the rate for June and its projection for July suggested that the alternative B specifications were not unrealistic and that they were in line with the objective of restoring monetary growth to a rate of about 5-1/4 per cent.

Concerning the Federal funds rate, Mr. Francis said he favored a widening of the range. From his observations while on the daily call during the past 4 weeks, he had concluded that the narrow range had led to more rapid expansion of the aggregates than desired by the Committee; the Desk needed more leeway. A spread from 7-1/2 to 9-1/2 per cent did not mean that the Desk had to use either extreme, but it gave the Desk sufficient flexibility to enable it to accomplish the Committee's objectives for the aggregates somewhat better than in the past.

Mr. Debs commented that both the staff presentation yesterday and the discussion this morning indicated that the economic situation was very uncertain. In the circumstances, and in response to the questions posed by the Chairman, he said that he would be willing to tolerate a higher funds rate and higher interest rates generally if that appeared necessary in order to restrain growth of the aggregates. Although everyone hoped that the price freeze and the Phase IV program to follow would improve the situation, no one knew whether or to what extent they would. Looking ahead, one could see a slowing down in the economy over the rest of 1973 and throughout next year. However, as the Chairman had pointed out, inflationary pressures were the more immediate danger.

In the quarter that was just ending, moreover, growth in the monetary aggregates was strong. In the circumstances, the Committee's more pressing objective should be to get a firm grip on the aggregates.

In terms of specific targets, Mr. Debs said he favored the longer-run target of growth in M_1 at a rate of 4-1/2 per cent, as specified in alternative B. However, the 6 to 8 per cent range of tolerance specified for the June-July period presented a problem. The rate projected for June, which the Committee could no longer influence significantly, was 9 per cent. Therefore, a range of 6 to 8 per cent for the June-July period suggested that a rate as high as 7 per cent in July would be acceptable, even though a rate of 5 per cent was projected. In order to enable the Desk to react if it appeared that the rate for July would exceed 5 per cent, he would set the upper limit of the range for the June-July period at 7 per cent. Moreover, he would set the lower limit at 4 per cent so that the Desk would not be required to lower the funds rate in the event of a temporary shortfall in the aggregates. For the funds rate, he would set the lower limit at 8 per cent, because he would not want the rate to fall from its present level unless growth in the aggregates appeared to be falling substantially short of that expected, and the upper limit at 9-1/4 per cent. While he understood the arguments that had been made for a wider range for the funds rate, he would not favor one as wide as 2 percentage points, especially in view of the present uncertainties. Should the behavior of the aggregates in the next few weeks suggest the desirability of a move in the funds rate beyond the range of 8 to 9-1/4 per cent, the Committee could always make an interim adjustment in the range, and because of existing uncertainties, it would be particularly desirable for Committee members to watch developments closely. He favored alternative B for the operational paragraph of the directive, except that--in view of the current international situation--he would restore the instruction to take account of international developments, which the staff had suggested be deleted.

Concerning the directive language, Mr. Brimmer remarked that the statement relating to foreign exchange market developments in the draft of the first general paragraph included a reference to the "absence of intervention by central banks." He would prefer to omit that reference because of the possibility of mistaken interpretations.

After discussion, the Committee agreed with the language suggestions of both Mr. Debs and Mr. Brimmer.

Mr. Debs noted that his final comment was on a policy matter not within the province of the Committee. He would think it timely for the Board of Governors to consider actions to increase interest rate ceilings on small savings deposits, perhaps by one-half of a percentage point.

Chairman Burns observed that the Board had the issue of interest rate ceilings under discussion but that it could not do anything until the Congress had passed the necessary legislation.

Mr. Coldwell commented that because of a fundamental concern over the intense inflation, he would be willing to tolerate additional monetary restraint. International developments added to the need for further restraint over coming months. His recommendation for a policy of further restraint would focus on bank reserves and bank lending rather than on M_1; the focus on intermediate- and longer-run targets for M_1 had not served the Committee well. For that reason he would prefer to have the operational paragraph of the directive say merely that "the Committee seeks to achieve bank reserve and money market conditions consistent with slower growth in monetary aggregates over the months immediately ahead," without adding the words "than appears indicated for the first half of the year."

Chairman Burns noted that growth in M_1 was at an annual rate of 11 per cent in May; it was projected at a rate of 9 per cent in June and could prove to be even higher. A call merely for slower growth, therefore, would be ambiguous; it might be interpreted to mean a rate slower than 11 per cent or 9 per cent. If the Committee intended to slow growth from those high rates, as he believed it should, it was preferable to call for slower growth than in the first half of the year, when the average rate was about 5.5 per cent. However, the Committee would debate the language of the operational paragraph later in the meeting.

Mr. MacLaury observed that he, like Mr. Brimmer, wished to commend the staff for presenting in the blue book a review of the performance of the money stock in relation to the Committee's longer-run targets as opposed merely to projecting alternative paths from the current level. If the emphasis on longer-run targets for the aggregates was going to be meaningful, the Committee needed such reviews.

Continuing, Mr. MacLaury commented that he agreed with the Chairman's view that the issue before the Committee today was whether it wished to pursue additional monetary restraint and was prepared to accept increases in the Federal funds rate and in interest rates generally. He was disturbed, however, by the discussion of the need for greater flexibility in the funds rate; he believed there was some confusion between the desirability of a wider range for the inter-meeting period, on the one hand, and that of larger movements from month to month, on the other hand. If the Committee had erred in the past, it had done so by moving the rate quickly in a short period and then holding it steady for some time. Last autumn and again earlier in the spring, for example, the Committee had halted an upward movement in the funds rate because the aggregates appeared to be growing at relatively low rates. In his judgment the need was not for a wider range within a period but for greater flexibility in movements from one period to the next.

In the current situation, Mr. MacLaury said, the Committee should permit short-term interest rates to rise somewhat further. He was sensitive to the concern that much additional restraint might precipitate a recession. However, the Committee's credibility, in the face of the explosive growth in the aggregates, required that it demonstrate its continuing concern by allowing the funds rate to rise somewhat further. In effect, the Committee had to balance the immediate effects that its policy actions would have on psychology with the future effects those actions would have on economic activity. In the period until the next meeting, the funds rate should not be permitted to fall below 8-1/4 per cent--unless some unexpected event occurred, in which case the Committee could consult prior to the meeting. The rate should not be permitted to rise above 9-1/4 per cent because that would represent a further substantial tightening of policy, if one defined policy in that way. The Committee could decide at the next meeting whether it wished to allow the rate to rise beyond 9-1/4 per cent. With respect to the June-July range for growth in M_1, he thought Mr. Debs' argument was well taken. While he was willing to set the range at either 4 to 7 or 5 to 7 per cent, he thought it was necessary to seek to slow growth, at least within the limits imposed by the funds rate constraint.

Mr. Mayo, noting that several statements had been made about a slowing down in the economic expansion and a possible downturn later on, observed that in a meeting at the Chicago Bank virtually all 25 leading business economists from the mid-West had reported that there was no evidence in the operations of their own companies and industries to suggest any near-term deterioration in the economic situation. Nevertheless, a great deal of weight had to be placed on the staff projections presented yesterday afternoon, and the Committee had to be concerned about both the current inflation and the possibility of a recession in growth, if not an actual downturn. He continued to favor a longer-run target for M_1 of 5-1/4 per cent, projected from the present level. While recognizing that growth in M_1 in recent months had exceeded the target rate of 5-1/4 per cent adopted in March, efforts to compensate for overshoots might do more harm than good.

Continuing, Mr. Mayo remarked that commercial bankers in the mid-West appeared to have adopted all of the rhetoric of rationing credit, limiting commitments, avoiding speculative loans, and turning away inquiries. However, the figures that accompanied the rhetoric did not suggest that bank loans would soon peak.

Concerning specifications Mr. Mayo said he would lean closer to those of alternative A than to those of alternative B, and he would be inclined to reduce the lower end of the June-July range for M_1 so that moderate shortfalls would not lead to an easing in bank reserve and money market conditions. With respect to the funds rate, greater flexibility both for the inter-meeting period and over the longer run had appeared desirable for some time, and he favored a range of 7 to 9 per cent. In the operational paragraph of the directive, he would prefer to call for moderate growth in the monetary aggregates over the months immediately ahead.

Mr. Holland observed that he wanted somewhat more monetary restraint at this juncture, but the Committee needed to be careful because of the time lags between policy actions and their effects on the economy. For that reason and a variety of others, the relevant liquidity measures included more than just M_1. Interest rates had reached ranges where for any given amount of downward pressure that could be applied to M_1, the downward pressure that would be exerted on M_2, on M_3, and on prices of various types of financial assets would be greater than it had been. The specifications presented by the staff were consistent with that view. Therefore, while accepting the language of alternative B, he would suggest that the Manager be very wary of moving the funds rate above 9 per cent and that the Manager consult with the Chairman, if not with the full Committee, before moving the rate above that level. At the same time, because a number of temporary factors probably had influenced the second-quarter bulge in M_1 and because the new price freeze might reduce the demand for money, the Desk should not operate to resist shortfalls from paths for the aggregates, should they develop. Accordingly, he would reduce the lower end of the 2-month ranges of tolerance for the aggregates by about 2 percentage points.

Mr. Daane remarked that he did not think that at this time the objectives and implementation of monetary policy should be couched in terms of longer-run targets for growth in the aggregates and deviations from the short-run paths associated with those targets. He would reject the idea that the Committee should set an absolute ceiling on the rate of monetary growth and accept whatever the consequences might be for interest rates. Instead, the Committee needed to face directly the difficult question of whether it wished to pursue a tighter policy at this juncture. As Messrs. Eastburn, Black, and others had pointed out, the members needed to be mindful of the risks involved in additional restraint at this stage of the business cycle. He felt very strongly, however, that distrust of the dollar had become contagious both at home and abroad, and in view of the recent explosive growth in the aggregates, he could not accept a recommendation that the Committee stand still. Additional tightening was necessary, despite the risks, and he would tighten further as much as possible without causing disruption in financial markets. As such a policy showed through, it would be reassuring to market participants abroad as well as at home.

Continuing, Mr. Daane remarked that to avoid explosive increases in interest rates, the language of the directive should focus on money market and credit conditions in the period immediately ahead--in the period until the next meeting of the Committee. Then, having passed through that period, the focus could be shifted back to rates of growth in the monetary aggregates if the Committee deemed it appropriate, although he remained skeptical of trying to run on the aggregates. Noting that he was delighted to have the reference to international developments restored to the operational paragraph, he would have it say, "To implement this policy while taking account of international and domestic financial market developments, the Committee seeks to achieve firmer bank reserve and money market conditions consistent with slower growth in the monetary aggregates." While he would prefer to stop there, he would not object to adding, "over the months immediately ahead." He would object to calling for slower growth "than appears indicated for the first half of the year" as unnecessarily clouding the prescription, which should call clearly for further tightening.

Mr. Sheehan noted that the staff projections of economic developments 6 to 9 months ahead suggested that real growth would be very low in the first half of next year and even lower in the fourth quarter. Against that background, he was impressed by the views of Messrs. Eastburn and Black. It had been his personal feeling that activity in the fourth quarter of 1973 and the first quarter of next year would be stronger than projected by the staff. However, in his prior business experience he had always had difficulty in forecasting turning points in economic activity, and perhaps he would be missing a turning point again in trusting his feeling about the period ahead.

Continuing, Mr. Sheehan remarked that he would be very disturbed to see as sharp an increase in interest rates over the next 30 days as had occurred in the preceding 30 days. Despite public statements on behalf of the System, particularly those by the Chairman, there was much public concern that a credit crunch might be developing. To those who look at interest rates rather than at rates of monetary growth, a further run-up in the funds rate to around 9-1/2 per cent would be a source of uncertainty about a crunch rather than a source of reassurance that the System was moving against inflation. It was true that, given the rate of growth in M_1 in recent weeks, those who focus on monetary growth might construe System actions as demonstrating a lack of concern about inflation, but the recent increase of one-half of a point in the discount rate should certainly have been perceived as an attempt to move against the inflation problem. On balance, he was much more concerned about the unsettling effects of a further sharp run-up in interest rates. Perhaps in the current situation it would be helpful if the System engaged in more public comment about its policy actions than it normally did.

With respect to the policy alternatives, Mr. Sheehan said he was inclined to come down hard for alternative A. Many had already spoken in favor of alternative B, but if there also was substantial sentiment for alternative A the best solution would be a compromise between the two. He would set an upper limit of 9 per cent on the funds rate, preferring to have an inter-meeting consultation before allowing the rate to move up to 9-1/2 per cent. Widening the range for the funds rate was desirable; the range had been too narrow in the past 3 or 4 months, which had hampered operations by the Desk. Accordingly, he would set the lower limit at 7 per cent. He preferred the language of alternative A, wishing to have a little more restraint but not very much more.

Mr. Daane, responding to Mr. Sheehan's remarks, observed that it was the thrust of his own position that the Committee could run operations more delicately in terms of pressures on interest rates--more delicately and steadily, with a better hand on the throttle--by focusing on money market conditions than by operating in reaction to deviations in the monetary aggregates from the growth paths expected, with the funds rate ceiling either moved or honored in the breach. There would be less risk of the developments that Mr. Sheehan feared if the Committee followed an interest rate course. In short, if he were determining policy all on his own, he would seek to reduce reserve availability and make it even more costly for banks to borrow funds, including at the Federal Reserve.

Mr. Sheehan said he would lean in that direction.

Mr. Mitchell observed that it would be helpful to Committee members if Mr. Daane indicated the ceiling for the funds rate that would be consistent with both orderly conditions in the markets and a signal of the System's concern.

In response, Mr. Daane said he would press on reserves and move the funds rate up to 8-3/4 or 9 per cent, from the current level of about 8-1/2 per cent, and observe the effects on the structure of interest rates. Reflecting reserve pressures, if the funds rate moved up without disrupting the markets, he would probe to move it up further. He would give the Manager more latitude, rather than tie him to a particular range for the rate; he would simply say to the Manager, in the old tradition, that the Committee wished to have additional tightening and to have it show through but that, in the present circumstances, operations had to be conducted cautiously. Hopefully, other short-term rates would move up a little, and the rate on 3-month Treasury bills would begin to respond more to the rise in the funds rate.

Mr. Mitchell asked--in connection with Mr. Daane's policy prescription--what Mr. Sternlight thought the market's response would be if the funds rate were moved up to 9-1/2 per cent during the next 2 to 3 weeks. He asked whether, in the light of recent developments, a further rise in the funds rate toward 9-1/2 per cent would not have some important effects on long-term rates.

Mr. Sternlight replied that a further rise in the funds rate would have a prompt impact on short-term rates in general. Should the rise be to 9 per cent or a little above, the impact on intermediate- and long-term rates might continue to be quite moderate. The impact of an increase to 9-1/2 per cent was more uncertain; a move in the rate to that area could provoke stronger reactions.

Mr. Morris commented that because of the sharp rise in prices in recent months, one might easily overestimate the strength in the economy; all of the indicators stated in current dollars looked much stronger than they really were. The staff at the Boston Bank had constructed a deflated index of leading indicators, incorporating 11 of the 12 components of the published index. The price index for raw materials had been omitted because it had seemed inappropriate to deflate a price index. The over-all deflated measure performed quite differently from the published index: in April, it was back down to its level of last October.

Chairman Burns observed that the price index for raw materials might be deflated by the general wholesale price index, thereby removing the influence of the rise in the general level of prices.

Resuming, Mr. Morris remarked that he had long advocated redefining M_1 to include U.S. Treasury deposits, and he thought that the economy was passing through another period in which the existing definition caused problems of interpretation. In the first quarter, Treasury deposits had increased substantially in association with the international disturbances, and the System had supplied enough reserves to the banking system to support those deposits. However, M_1, as presently calculated, had grown at a slow rate, giving a false impression of the degree of restraint being imposed by the System. In the current quarter, the running down of Treasury deposits was contributing to the bulge in M_1, creating the impression that monetary policy was not as restrictive as in fact it was.

Nonetheless, Mr. Morris said, it was necessary to regain control of growth in the aggregates--not only because of the consequences for economic activity over the longer term but also because of the effects on psychology in the short run. Another month or two of high rates of growth in the aggregates would be very damaging to psychology, abroad as well as at home. If necessary to moderate growth, a further rise in the Federal funds rate over the next 5 weeks would be acceptable. However, the staff might well be correct in its view that the objectives of alternative B--which he favored--could be accomplished without much further rise in the funds rate; the effects of the decline in the Treasury's cash position--which, as he had said, might have been an independent source of strength in M_1 in the second quarter--were now past. Like Mr. Holland, he would accept shortfalls in growth of the aggregates over the next 5 weeks, if they should develop, and he would support Mr. Holland's suggestion that the lower end of the June-July range for growth in M_1 be reduced. To be consistent with the willingness to accept shortfalls in the aggregates, he would raise the lower end of the range for the funds rate, making the range 8 to 9-1/2 per cent.

Mr. Winn observed that there were four or five issues that worried him and made him more concerned about real inflationary pressures and inflationary psychology than some others might be. The energy crisis was likely to require major expenditures that would have to be made without regard to the market situation. Similarly, the harvesting of crops later in the year would reveal that the country's transportation system was inadequate, and major expenditures would be mandatory. The strong economic situation in other countries might well lead to larger foreign demands for exports from the United States than had been projected. Consequently, he would favor a more restrictive policy in the period immediately ahead than some others had favored. In view of recent experience, the Committee would be lucky if it could achieve any of the three alternatives presented in the blue book, whose over-all range for growth in M_1 in the June-July period extended only from an annual rate of 5.5 per cent to 8.5 per cent. With respect to the funds rate, he would not be disturbed to see it moved up gradually to 9-1/2 per cent.

Mr. Kimbrel said he favored a monetary policy of slightly more restraint and would be willing to accept wider ranges for the Federal funds rate consistent with that objective. He would like the System to pursue as much firmness as possible, short of disrupting financial markets, and would want that policy to be evident in the markets. Many of the businessmen with whom he had talked recently were rather skeptical about the effects of price and wage controls. Moreover, they repeatedly cited shortages of materials, shortages of labor, and shortages of capacity, but none suggested that difficulties arose because of a shortage of funds. Commercial bankers reported that they were exercising considerable restraint in their lending activities, but the data they furnished revealed large increases in total loans. Outside the banking system, it had been suggested, funds were being put to very speculative uses. And there were scattered reports that the Home Loan Bank was encouraging savings and loan associations to borrow for the purpose of making additional commitments--which seemed inappropriate, considering the large rise in prices in the Sixth District. With such problems in mind, he favored the specifications of alternative B in the hope that monetary growth would be slowed.

Mr. Bucher commented that he had found Mr. Mitchell's remarks especially useful. Also, in his view, Mr. MacLaury had identified the issues very well when he spoke of the need to balance the immediate effects that further restraint would have on psychology against the longer-term effects such a policy would have on an economy that might be cooling off. More than ever, the Committee needed to resist the temptation to overreact. He would continue in a tightening posture without undue concern about a 2-month jump in the aggregates, which had tended to move erratically. Like Mr. Holland, he felt that some temporary influences were at work to raise the rate of monetary growth in the recent period. Consequently, he leaned toward the specifications of alternative A. For the funds rate--although not fully accepting the idea of a wider range--he thought that a range of 7 to 9 per cent would be consistent with his objectives for the period immediately ahead. Concerning the language of the directive, Mr. Bucher said he favored Mr. Daane's proposal. Although he had recommended in the past that the Committee use more specific language in the operational paragraph, he had not seen any suggestions that represented improvement over the general language the Committee had been using.

Mr. Clay remarked that the projections suggested some weakness in the economy 6 to 9 months ahead, and the Committee might wish to deal with that if it could afford the luxury. If the Committee's actions were invisible to market participants here and abroad, that might be the proper course. However, there was a current problem of inflation and the economy had been expanding at a rate that could not be sustained, so that any easing of monetary policy would have bad psychological effects. The Committee had to continue to deal with the primary problem of inflation and hope that, when the time came, it would be able to reverse policy soon enough to avoid a serious weakening in the economy. Therefore, he favored alternative B, hoping that some progress would be made to suggest that inflation would be brought under control and that the progress would be perceived by market participants here and abroad.

Mr. Brimmer commented that he would prefer to set the upper limit of the Federal funds rate range closer to 9-1/2 than to 9 per cent. At the previous meeting the Committee had set the upper limit for the funds rate at 7-7/8 per cent, but the members had agreed to raise that limit to 8-1/4 per cent on May 24 and then to 8-1/2 per cent on June 8. In his view, the Desk would have been able to move more quickly to intercept the overshoots in the aggregates if it had had more leeway in the funds rate from the outset of the inter-meeting period.

Chairman Burns observed that, having been in contact with the Manager continually during the period, he did not believe that operations had been hampered because the Committee had not specified a higher limit for the funds rate initially instead of raising the limit during the inter-meeting period. He asked Mr. Sternlight to comment on operations in that period.

Mr. Sternlight said action by the Desk had been reasonably timely--that there had not been significant delay because of the need to obtain Committee approval for raising the upper end of the range for the funds rate. Had the Committee initially set the upper limit of the range at 8-1/2 per cent without also instructing that the rate immediately be moved toward the upper limit, the Desk would have followed past practice and made only modest moves in that direction.

Mr. Brimmer commented that as he interpreted developments during the period, when it had appeared persistently that growth in the aggregates would exceed the ranges set by the Committee, the upper limit for the funds rate had been a constraint on operations until, in each case, the limit had been adjusted upward. He would prefer to specify a wider range for the funds rate--with an upper limit of 9-1/2 per cent in the period until the next meeting--and he would favor giving the Manager the freedom to use the full range without having to wait for additional Committee consultations.

Mr. Sheehan asked Mr. Sternlight whether the delay between the time that the Manager had perceived a need for an increase in the upper limit of the funds rate range and the time the Committee had raised it was more than a matter of hours and whether that delay had caused any difficulties in operations.

In reply, Mr. Sternlight said he did not think there had been a significant delay. On occasions, judgments might differ concerning the establishment of a higher target for the funds rate one day, on the basis of preliminary estimates of growth in the aggregates in a statement week, or waiting until the following day when more complete data would enable the staff to firm up the estimates.

Chairman Burns then suggested that Committee members be polled informally on two issues: their preferences for the language of the operational paragraph of the directive as between that of alternative B, including a reference to international developments, and that proposed by Mr. Daane; and their preferences for the longer-run targets for growth in the aggregates. The first poll indicated that seven members preferred the language of alternative B and three favored that proposed by Mr. Daane. With respect to the longer-run targets, eight members favored those of alternative B, namely, annual rates of growth over the third and fourth quarters combined of 4-1/2 per cent for M_1, 5 per cent for M_2, and 8-3/4 per cent for the credit proxy.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's drafts of the general paragraphs--amended, as agreed earlier, to drop the reference to central bank intervention in foreign exchange markets--and alternative B of the operational paragraph, on the understanding that it would be interpreted in accordance with the following specifications. The longer-run targets--that is, the annual rates of growth over the third and fourth quarters combined--would be taken as 4-1/2 per cent for M_1, 5 per cent for M_2, and 8-3/4 per cent for the credit proxy. The short-run operating ranges--that is, annual rates of growth for the June-July period--would be taken as 8 to 11-1/2 per cent for RPD's, 4 to 8 per cent for M_1, and 5 to 8 per cent for M_2. The range of tolerance in the daily-average Federal funds rate for statement weeks in the period until the next meeting would be 7-3/4 to 9-1/4 per cent. He observed that, as recent experience had demonstrated, changes in the specifications could be made in the inter-meeting period with some frequency and speed.

Mr. Debs remarked that some additional guidance for the Manager might be desirable because the June-July range of 4 to 8 per cent for M_1--given the latest estimate for June--allowed for the possibility of a rate of growth in July as high as 7 per cent, or 2 percentage points above the rate projected by the staff.

Chairman Burns responded that he and the Manager were in frequent communication between meetings and that, if the problem arose, he would set in motion the machinery to deal with it.

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

The information reviewed at this meeting, including recent developments in industrial production, employment, and retail sales, suggests that growth in economic activity is slowing in the current quarter from an exceptionally rapid pace in the two preceding quarters. The unemployment rate has remained at 5 per cent. Wage rates have advanced moderately thus far this year, but the rise in both wholesale and retail prices has been exceptionally rapid. On June 13 the President announced that prices will be frozen for a maximum of 60 days while a new and more effective system of controls is developed. Phase III controls affecting wages, profit margins, dividends, and interest rates remain in effect. In foreign exchange markets, several European currencies have appreciated against the dollar by 7 to 10 per cent since early May. The U.S. merchandise trade balance continued to improve in April, as exports other than agricultural products increased sharply further and imports dipped.

Following relatively slow growth earlier in the year, the narrowly defined money stock rose sharply in May and early June. Growth in consumer-type time and savings deposits changed little, while banks' net sales of large-denomination CD's declined further. On May 16 marginal reserve requirements were imposed on large-denomination CD's and the remaining Regulation Q ceilings on such CD's were suspended. Business loan demands have remained strong, and since mid-May short-term market interest rates have advanced considerably further. Interest rates on long-term market securities in general have risen somewhat. On June 11 Federal Reserve discount rates were raised one-half point to 6-1/2 per cent.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to abatement of inflationary pressures, a more sustainable rate of advance in economic activity, and progress toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months immediately ahead than appears indicated for the first half of the year.

Mr. Daane commented that he had voted for the directive very reluctantly. He did not disagree with its thrust in terms of a policy of some further tightening, but as he had argued earlier, the continued emphasis on the aggregates in the conduct of operations did not seem desirable in the current situation.

Secretary's note: The specifications agreed upon by the Committee, in the form distributed following the meeting, are appended to this memorandum as Attachment D.

Chairman Burns then referred to the report prepared at the Dallas Bank entitled "Agressive Bank Contacts." He invited Mr. Coldwell to comment on the results of those contacts and to suggest steps that might be taken in the weeks ahead.

Mr. Coldwell noted that by letter from Mr. Holland dated May 23, 1973, the Reserve Bank Presidents had been encouraged to arrange meetings with a few of the more aggressive lending banks in their respective Districts to reinforce the impact of the May 22 letter sent by Chairman Burns to all member banks, urging restraint in their lending activities. As a result of that request the Presidents had contacted a total of 64 banks, holding almost $100 billion in deposits. Two of those banks were completely uncooperative, and a few others were critical of the effort to employ moral suasion, believing that quantitative controls were a more appropriate means of achieving restraint. The great majority, however, promised to cooperate and a surprising number indicated that they had already adopted a more restrictive lending policy--some as early as February or March. It remained to be seen, of course, whether their efforts would in fact result in further restraint on bank credit and reduced pressure on markets for Federal funds, CD's, Euro-dollars, and other sources of funds. A number of banks indicated that some time might be required for their efforts to be reflected in loan volume, in part because of their need to honor outstanding commitments.

As to the next step, Mr. Coldwell continued, he would suggest that the Presidents monitor substantially the same group of banks as that covered in the initial contacts, although some Presidents might find it desirable to add or subtract a few banks from the group. Specifically, he would propose that the banks in question be checked again in early July, to determine whether the effort had achieved measurable results. As a measure of effectiveness, he would propose comparing the rate at which the banks were extending credit and the degree to which they were relying on CD's and various nondeposit sources of funds in a five-week period ending in early July with corresponding figures for the nine-week period ending May 30.

The Chairman then invited Mr. Daane to comment on the Basle meeting that he had attended during the past weekend.

Mr. Daane observed that because the June meeting at Basle was held in association with the annual meeting of the BIS, the usual Sunday night governors' dinner was omitted and the governors held one business session--on Sunday afternoon--rather than the customary two. The session involved a "tour d'horizon" of those present. Among the more interesting aspects of the discussion was the indication that the outgoing Governor of the Bank of England was quite concerned about the prospects for a massive deficit in Britain's balance of payments this year. It was clear that the German monetary authorities were focusing on domestic objectives rather than international developments, and the President of the German Federal Bank expressed cautious optimism about their prospects for moderating domestic inflationary pressures. The Japanese anticipated a substantial balance of payments surplus this year, but one that was much smaller than that recorded last year.

Mr. Daane noted that much of the discussion was focused on three questions that had been posed by President Zijlstra, of which the first related to the extent to which the governors expected the recent changes in exchange rates to affect their international payments relationships in the period ahead. In his summary, Dr. Zijlstra cautioned the governors against undue pessimism on that score--a position which he (Mr. Daane) certainly would subscribe to with respect to the U.S. payments balance, and which was supported by yesterday's staff presentation. On another subject, Dr. Zijlstra cited his own country as offering a clear example of the proposition that to control inflation it was not sufficient to remove demand inflation; he indicated that despite an ending of demand inflation in the Netherlands that country was still experiencing severe inflationary pressures of the cost-push variety. That proposition was discussed at some length. Finally, there was an evident feeling--except on the part of the French, who did not comment on the point--that up until the present it had been best for central banks not to intervene in foreign exchange markets, but that they should remain in close contact because conditions might soon develop at which intervention could produce dramatic results.

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 May 15 through June 13, 1973, and a supplemental report covering the period June 14 through 18, 1973. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs made the following statement:

> Since the last meeting of the Committee the exchange markets have been demoralized and disorderly, in an atmosphere of deepening distrust of the dollar, both at home and abroad. As some commentators have noted, there has been no crisis in the conventional sense of massive flows of hot money into foreign central banks, such as occurred prior to March of this year. Under the earlier system, foreign central banks were punished not only by the inflationary impact of such inflows but also by subsequent heavy losses on their dollar reserve accumulations. This time they have insulated themselves by refusing to buy dollars, while we are taking the brunt of the punishment in the form of a sharply depreciating dollar. The slide in the dollar has seriously aggravated our domestic inflation, generated speculation in the commodity markets, and further endangered our balance of payments position by inciting new capital outflows. During the past month two foreign central banks have practically cleaned out their accounts at the New York Reserve Bank and several others have broken their parity links to the dollar and are now pegging against the European currencies. I would expect more of the same if the dollar remains weak. To me, this is a crisis.
>
> Historically, countries have generally had some pretty good reasons for defending the external value of their currencies. One of the basic reasons is that domestic stabilization programs can readily be frustrated by the inflationary and other adverse effects

of exchange depreciation. This is why the British government has recently put a firm floor under sterling by a $2 billion program of Euro-dollar borrowing. The Italian government is similarly trying to reinforce a new program of domestic stabilization by rounding up a big package of foreign credits to stabilize the external value of the lira. In our own situation, with the dollar now regarded as undervalued, at least for the time being, I can see virtually nothing to be gained and much to be lost by further depreciation of its external value.

Until now, I have not felt that the timing was right for a resumption of Federal Reserve exchange operations. But, with the new price freeze announced last week, the sharp rise of short-term rates, and clear signs of a favorable turn in our trade balance, I think we may be getting close to the point at which action would be appropriate.

Meanwhile, last week I received clearance to approach the Japanese and Canadians with respect to a doubling of our swap lines with them. They have agreed in principle. Also, I have firm assurances from the European central banks I had approached earlier on the same subject. I think we could now arrange, on 48 or even 24 hours' notice, the following swap line increases: $1 billion each in the lines with the central banks of France, Germany, Japan, and Canada; $750 million in the line with the Bank of Italy; and $400 million each in the lines with the central banks of Switzerland, Belgium, and the Netherlands.

Such increases would total $5,950 million, compared with the $6 billion aggregate increase authorized by the Committee at its meeting on March 20, 1973, and they would raise the over-all swap network from $11,730 million to $17,680 million. Having gone this far, it now seems to me that there might be some advantage in lifting the total closer to the figure of $18 billion, by increasing the lines with the central banks of Denmark, Norway, Sweden, Mexico, and Austria by $50 million each. I will return to this point in connection with my recommendations.

I would hope, and the European central banks generally share this view, that we would not announce the swap line increases until we are ready to go into the market. By so timing the announcement, I think we would have a much greater impact on market psychology.

> Before activating the swap lines, one more obstacle has to be cleared away: the question of the revaluation clause. There is outstanding the German proposal, supported by France and Belgium, that profits and losses resulting from Federal Reserve swap drawings settled at rates more than 2-1/4 above or below par should be shared equally by the System and its creditors. During this floating rate period, I am doubtful that we can negotiate any more favorable arrangement. If action on the revaluation clause becomes imperative before the next meeting of the Committee, I would hope that an interim decision could be made by the Subcommittee, consisting of the Chairman and Vice Chairman of the Committee and Mr. Mitchell.

By unanimous vote, the System open market transactions in foreign currencies during the period May 15 through June 18, 1973, were approved, ratified, and confirmed.

In reply to a question by Mr. Daane, Mr. Coombs said the proposal to share profits and losses did not apply to drawings on the System by other central banks. In connection with any such drawings, the repayment provisions and risks would be exactly as they had been in the past.

In response to a question by Mr. Brimmer, Mr. Coombs said he did not believe the Treasury was contemplating taking any actions with respect to swap arrangements of its own. It was his understanding, however, that the Treasury had agreed with the Committee's decision at its March meeting to authorize negotiations looking toward increases in the swap lines aggregating up to $6 billion.

Mr. Francis remarked that he, for one, would be reluctant at this point to draw on the swap lines for the purpose of intervening in foreign exchange markets in an effort to modify the position of the dollar relative to that of other currencies.

Mr. Brimmer observed that his willingness to undertake intervention operations would depend in part on the outlook for the U.S. capital control program, because the effects of System operations might be offset to some extent if restrictions on the movements of capital were relaxed. If, as Mr. Coombs suggested, an announcement of swap line increases was not to be made until the System was ready to intervene in the market, he would not favor authorizing such an announcement at this point.

Mr. Daane commented that he would not want to prejudge the issue of intervention; as Mr. Coombs had indicated, the time might well be near when System operations could prove useful in changing attitudes toward the dollar.

Chairman Burns noted that Mr. Coombs was already authorized to negotiate increases in the swap lines aggregating up to $6 billion. In his judgment, it would be unwise for the Committee to attempt to place restrictions today on any announcements of swap line increases. Questions regarding such announcements, like those regarding market intervention, could involve basic issues of foreign policy and would therefore need to be discussed within the Government.

Mr. MacLaury observed that Mr. Coombs had proposed coordinating the timing of the announcement with that of the resumption of operations by the System. He asked whether the Chairman would contemplate having the Desk begin to intervene in the exchange market without further discussion by the Committee.

Chairman Burns replied that, as Mr. Coombs had mentioned, an agreement between the Federal Reserve and its swap partners with respect to exchange risks was necessary before intervention could be undertaken. Assuming such an agreement was reached, it was still far from clear at the moment whether--or when--it would appear desirable to launch operations. He would suggest, however, that the Subcommittee be authorized to act without bringing the matter back to the full Committee, should circumstances arise under which the Subcommittee members and Administration officials agreed that the time to intervene had arrived.

Mr. Mitchell remarked that he would not object to such a procedure. However, he thought it would be preferable if the full Committee could be given an opportunity to express its views on any proposals for intervention.

Mr. Holland noted that paragraph 6 of the Committee's foreign currency authorization specified that actions by the Subcommittee under the provisions of that paragraph "shall be reported promptly to the Committee." He asked whether the Chairman would contemplate similar prompt reporting if the Subcommittee were authorized to act on behalf of the Committee in the present matter.

Chairman Burns replied that he would propose not only to be in touch with the Committee promptly after any action by the Subcommittee but in advance of such action if at all possible. He agreed that it would be highly desirable to have the exchange of views Mr. Mitchell had suggested if time were available.

Mr. Francis observed that his attitude with respect to intervention would depend in part on whether some kind of understanding had been reached among all of the countries whose currencies would be involved.

The Chairman replied that he would consider it a basic rule of System foreign currency operations never to intervene in a currency without the concurrence of the central bank of the country involved. Any deviation from that rule could amount to engaging in a currency war, a course he was sure no one in the System would want to follow.

Mr. Brimmer said he accepted the fact that System operations in the exchange market could involve basic issues of foreign policy. Nevertheless, the Committee still had responsibilities in the area. It was hard for him to visualize circumstances under which it would not be possible to consult with the Committee before operations were undertaken, particularly since it had repeatedly proved feasible in the domestic area to get rapid responses from the members to inter-meeting inquiries on such matters as proposed changes in the constraint on the Federal funds rate.

Chairman Burns commented that he could conceive of a number of circumstances under which consultation with the Committee would not be feasible. For example, the President might decide at some point that foreign currency operations should be undertaken immediately. He would prefer to have the Subcommittee authorized to act so that in such an event he would not have to choose between disregarding the wishes of the President or those of the Committee. To illustrate his point about the foreign policy implications of the System's exchange market operations, he might remind the members that the decision in August 1971 to place the swap network in a state of suspension had been made by the President. In principle, of course, the Committee could have disregarded the President's decision.

Mr. MacLaury observed that the Committee certainly would never assert such a prerogative and attempt to make foreign policy. From his own experience in the area of foreign currency operations he fully recognized the need for flexibility in decision-making, and he agreed that the Subcommittee should have the authority the Chairman had suggested. At the same time, he would note that a decision to reenter the market in support of the dollar, following a period in which there had been no intervention, was of a different order from decisions relating to an ongoing program. He hoped it would prove possible for the Committee to have some input into any decision that might be taken concerning a resumption of operations.

The Chairman remarked that while he could not make a commitment to that effect so long as there was a possibility that he might not be able to carry it out, he wanted to assure the members that they would have an opportunity to discuss the matter if time permitted. As the members would recall, shortly before the meetings in Paris of Finance Ministers and central bank governors last March, the Committee had held a telephone conference because of the possibility that the question of intervention in exchange markets might be raised at the meetings. As it happened that question had been raised in Paris, and it had been very helpful to him to have had the opportunity to consult with the Committee in advance.

Mr. MacLaury commented that the Chairman's position with respect to a Committee discussion of intervention operations struck him as realistic and wholly acceptable.

Mr. Brimmer said he also was satisfied on the matter and would withdraw his earlier reservations about the proposal to delegate authority to the Subcommittee.

By unanimous vote, the Subcommittee consisting of the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board of Governors, or designated alternates, was authorized to act on behalf of the Committee with respect to questions relating to possible resumption of System foreign currency operations.

Mr. Coombs referred to his earlier comment regarding the desirability of expanding the System's swap network somewhat more than contemplated under the March 20 action by increasing the swap lines with the central banks of Denmark, Norway, Sweden, Austria, and Mexico by $50 million each. He recommended that he be authorized to negotiate those additional increases.

Mr. Holland said it was his impression that in the past Mr. Coombs had tended to recommend increases in swap lines only in cases where he thought there was a reasonable expectation that the larger amount might be needed. He gathered that Mr. Coombs had some different considerations in mind in connection with the present recommendation.

Mr. Coombs commented that in his judgment the additional increases would be welcomed by the five central banks concerned and would have the advantage of bringing the System's total swap network closer to the figure of $18 billion.

Chairman Burns remarked that he had no objection to the additional increases proposed.

By unanimous vote, the Committee authorized the Special Manager to negotiate increases of $50 million each in the System's swap lines with the central banks of Austria, Denmark, Mexico, Norway, and Sweden, on the understanding that those increases, and the corresponding amendments to paragraph 2 of the foreign currency authorization, would become effective on the same date as the swap line increases aggregating up to $6 billion for which negotiations had been authorized by the Committee on March 20, 1973.

Mr. Coombs then said he would recommend renewal, if necessary, of two System swap drawings on the National Bank of Belgium, totaling $65 million, that would mature on July 19 and 26, respectively. Since the Belgian swap line had been in continuous use for more than a year, renewal of the drawings required specific authorization by the Committee under the terms of paragraph 1D of the foreign currency authorization.

Chairman Burns asked about the prospects for repaying the System's outstanding swap debt.

In reply, Mr. Coombs said those prospects would depend on whether intervention operations--if and when they were undertaken--were successful in changing the atmosphere in the foreign exchange market, as they had been last summer. If so, it should then be possible to begin repaying the outstanding debt.

By unanimous vote, renewal for further periods of three months of the two System drawings on the National Bank of Belgium maturing on July 19 and 26, 1973, respectively, was authorized.

Chairman Burns said he thought the Committee had had a good meeting today and had reached the right conclusion on monetary policy. He would like to make two points regarding the domestic economy. First, in his judgment, the widespread talk about a recession was premature. Secondly, the course of economic activity in the period ahead would depend fundamentally on the state of confidence, and the present strongly restrictive stance of System policy represented a significant contribution to confidence. Under other circumstances, the recent extraordinary rise in interest rates and the early-June increase in the discount rate to its highest level in more than 50 years might well have brought the Federal Reserve under sharp attack in the press and in Congress; the fact that there had been no such attack was an indication that confidence in the System itself was high.

The Chairman noted that the System had already moved far in the direction of restraint and might well have to move further. At the same time, it was important to remain alert to any indications that the time had arrived for moving in the other direction. He hoped the System would not be so frozen into a posture of restraint that it could react only with a lag to a clear-cut change in economic conditions.

Mr. Mitchell observed that there had been no discussion following Mr. Coldwell's report earlier today on Reserve Bank contacts with aggressive commercial banks. He thought that report was extremely useful and that the program itself was a valuable one.

Chairman Burns remarked that he had not called for discussion of Mr. Coldwell's report only because of the pressure of time. He agreed with the sentiments Mr. Mitchell had expressed and assumed they were shared by others.

Mr. Eastburn noted that in a memorandum dated June 12, 1973, the Chairman had advised the Committee that he was appointing a Subcommittee to consider the desirability of including more quantitative information in the passages in the FOMC policy records reporting the Committee's policy decisions. He asked whether the Subcommittee would be interested in receiving expressions of views on the subject.

Mr. Daane replied that the Subcommittee would find such expressions extremely helpful.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, July 17, 1973, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

June 18, 1973

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 19, 1973

GENERAL PARAGRAPHS

The information reviewed at this meeting, including recent developments in industrial production, employment, and retail sales, suggests that growth in economic activity is slowing in the current quarter from an exceptionally rapid pace in the two preceding quarters. The unemployment rate has remained at 5 per cent. Wage rates have advanced moderately thus far this year, but the rise in both wholesale and retail prices has been exceptionally rapid. On June 13 the President announced that prices will be frozen for a maximum of 60 days while a new and more effective system of controls is developed. Phase III controls affecting wages, profit margins, dividends, and interest rates remain in effect. In foreign exchange markets, with absence of intervention by the central banks, several European currencies have appreciated against the dollar by 7 to 10 per cent since early May. The U.S. merchandise trade balance continued to improve in April, as exports other than agricultural products increased sharply further and imports dipped.

Following relatively slow growth earlier in the year, the narrowly defined money stock rose sharply in May and early June. Growth in consumer-type time and savings deposits changed little, while banks' net sales of large-denomination CD's declined further. On May 16 marginal reserve requirements were imposed on large-denomination CD's and the remaining Regulation Q ceilings on such CD's were suspended. Business loan demands have remained strong, and since mid-May short-term market interest rates have advanced considerably further. Interest rates on long-term market securities in general have risen somewhat. On June 11 Federal Reserve discount rates were raised one-half point to 6-1/2 per cent.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to abatement of inflationary pressures, a more sustainable rate of advance in economic activity, and progress toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months immediately ahead.

Alternative B

To implement this policy, while taking account of domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat slower growth in monetary aggregates over the months immediately ahead than appears indicated for the first half of the year.

Alternative C

To implement this policy, while taking account of domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with slower growth in monetary aggregates over the months immediately ahead than appears indicated for the first half of the year.

ATTACHMENT B

Description of contingency plans approved by Committee members on June 29, 1973

On June 27 and 28, 1973, members of the Federal Open Market Committee were informed of discussions then under way with U.S. Treasury officials concerning possible means for mitigating some of the adverse consequences for Federal finance of any delay in the enactment of new debt ceiling legislation then pending before Congress, which provided for the extension of the temporary $465 billion debt ceiling until November 30, 1973. The members were advised that, if this legislation was not enacted by June 30, 1973, the debt limit would decline on July 1 to its permanent level of $400 billion, approximately $60 billion below the debt estimated to be actually outstanding, and that until new legislation was enacted the Treasury would be unable to issue new securities or to replace maturing securities as long as the outstanding debt remained above $400 billion. The Treasury would be faced with immediate problems in that (1) it would be unable to issue the $1.8 billion of 339-day bills that had been auctioned on June 26, for payment on July 2, for the purposes of replacing $1.7 billion of bills maturing June 30 and raising $100 million of new money; and (2) it would be unable to proceed with its plans to auction on July 2, for payment on July 5, $2.5 billion of 3-month bills and $1.7 billion of 6-month bills in partial replacement of $4.3 billion of bills maturing July 5.

It was noted that the System could take delivery on June 30 of the $623 million of 339-day bills it had successfully bid for in the June 26 auction, and that on the same day it could exchange holdings of maturing bills for $1,075 million of new 3-month and $500 million of new 6-month bills which would normally be delivered on July 5.

The contingency plans that had been developed contemplated the adoption of a special FOMC authorization under which use would be made of the Federal Reserve Banks' statutory authority to hold up to $5 billion of U.S. Government securities acquired directly from the Treasury, on the understanding that the special authorization would become effective if and when the Chairman determined that such action was made necessary by the Treasury's financial requirements. The details of the plans are set forth in the following message, which was transmitted to Committee members on June 29, 1973:

"Please advise as soon as possible whether you vote to approve the following special FOMC authorization, on the understanding that it would become effective if and when the Chairman determines that the Treasury's financial requirements make it necessary:

"'Under Section 14(b) of the Federal Reserve Act (which provides in part that "...until July 1, 1973, any bonds, notes, or other obligations which are direct obligations of the United States... may be bought and sold without regard to maturities either in the open market or directly from or to the United States; but all such purchases and sales shall be made in accordance with the provisions of section 12A of this Act and the aggregate amount of such obligations acquired directly from the United States which is held at any one time by the twelve Federal Reserve Banks shall not exceed $5,000,000,000....") the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury on June 30, 1973:

A. for System Open Market Account, up to $1.175 billion of Treasury bills maturing on June 4, 1974, at rates equal to the average rates established in the Treasury's bill auction on June 26, 1973; and, if the Treasury is unable to deliver the bills auctioned on that date, because of delay in enactment of new debt ceiling legislation, to resell to successful bidders in that auction, for delivery on Monday, July 2, 1973, such amounts of 339-day bills as they would have received, at the prices they would have paid, had the Treasury been able to deliver the bills auctioned.

B. for System Open Market Account, up to $1.425 billion and $1.200 billion of Treasury bills maturing on October 4, 1973, and January 3, 1974, respectively, at interest rates comparable to prevailing rates on Government securities of similar type and maturity, and to auction such bills for cash and in exchange for publicly held 3-month and 6-month bills maturing on July 5, 1973.

C. for the account of the Federal Reserve Bank of New York, up to $1.200 billion of other U.S. Government securities at interest rates comparable to prevailing rates on Government securities of similar type and maturity.

"'Certain provisions of the authorization for domestic open market operations, specified below, are herewith suspended to the extent necessary to permit the implementation of the operations described above and to the extent consistent with existing law. The suspended provisions are (1) that of paragraph 1(a) limiting sales of U.S. Government securities to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York; (2) that of paragraph 1(a) limiting changes in the aggregate System Account holdings of U.S. Government and Federal agency securities between meetings of the Committee to $2.0 billion; (3) those of paragraph 2 specifying that securities purchased directly from the Treasury shall be for the account of the Federal Reserve Bank of New York unless that Bank is closed, and shall be limited to special short-term certificates of indebtedness bearing a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York; and (4) that of paragraph 2 limiting total holdings of securities purchased directly from the Treasury at any one time to $1 billion.'"

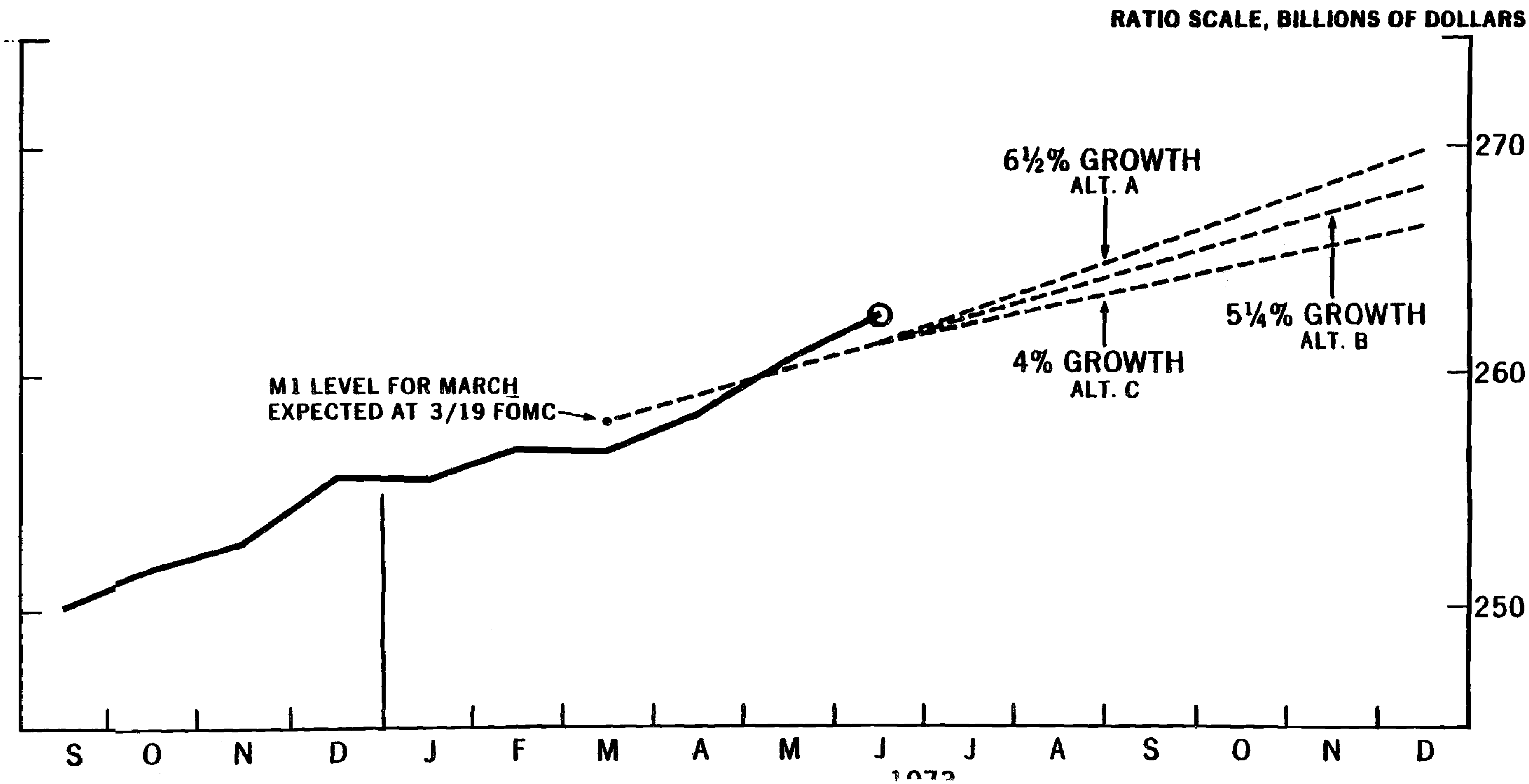
"For your information, the Desk plans to accept on June 30 a pre-refunding of its present holdings of the two issues of Treasury bills maturing on July 2 and July 5 in amounts, respectively, of $ .623 billion and $1.575 billion."

"'Certain provisions of the authorization for domestic open market operations, specified below, are herewith suspended to the extent necessary to permit the implementation of the operations described above and to the extent consistent with existing law. The suspended provisions are (1) that of paragraph 1(a) limiting sales of U.S. Government securities to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York; (2) that of paragraph 1(a) limiting changes in the aggregate System Account holdings of U.S. Government and Federal agency securities between meetings of the Committee to $2.0 billion; (3) those of paragraph 2 specifying that securities purchased directly from the Treasury shall be for the account of the Federal Reserve Bank of New York unless that Bank is closed, and shall be limited to special short-term certificates of indebtedness bearing a rate 1/4 of 1 per cent below the discount rate of the Federal Reserve Bank of New York; and (4) that of paragraph 2 limiting total holdings of securities purchased directly from the Treasury at any one time to $1 billion.'"

"For your information, the Desk plans to accept on June 30 a pre-refunding of its present holdings of the two issues of Treasury bills maturing on July 2 and July 5 in amounts, respectively, of $ .623 billion and $1.575 billion."

Committee members voted unanimously on June 29, 1973, to approve the contingent authorization described in this message. (Messrs. Debs and Winn, respectively, voted as alternates for Messrs. Hayes and Mayo, who were out of the country.) New debt ceiling legislation was passed by the Congress on the afternoon of June 30, 1973, and the Treasury advised that it was unnecessary to implement the contingency plans. Accordingly, Governor Mitchell (who was Acting Chairman of the FOMC on that day, in the absence of both Chairman Burns and Vice Chairman Hayes) did not make a determination that the special authorization was required, and that authorization did not become effective.

THE MONEY SUPPLY AND LONGER RUN TARGET PATHS



ATTACHMENT C

ATTACHMENT D

June 19, 1973

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 6/18-19/73)
A. Longer-run targets (SAAR): (third and fourth quarters combined)	M_1	4-1/2%
	M_2	5%
	Proxy	8-3/4%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (June-July average):		8 to 11-1/2%
2. Ranges of tolerance for monetary aggregates (June-July average):	M_1	4 to 8%
	M_2	5 to 8%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		7-3/4 to 9-1/4%
4. Federal funds rate to be moved in an orderly way within range of toleration		
5. Other considerations: account to be taken of international and domestic financial market developments.		

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.