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 16-17, 1975, beginning at 3:30 p.m. on Monday.

PRESENT: Mr. Burns, Chairman
Mr. Baughman
Mr. Bucher
Mr. Coldwell
Mr. Eastburn
Mr. Holland
Mr. MacLaury
Mr. Mayo
Mr. Mitchell
Mr. Wallich
Mr. Debs, Alternate for Mr. Hayes

Messrs. Balles, Black, Francis, and Winn, Alternate Members of the Federal Open Market Committee

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

Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)
Messrs. Boehne, Bryant, Davis, Green, Kareken, Reynolds, and Scheld, Associate Economists

Mr. Holmes, Manager, System Open Market Account
Mr. Sternlight, Deputy Manager for Domestic Operations
Mr. Pardee, Deputy Manager for Foreign Operations

Mr. Allison,[1/] Secretary of the Board of Governors
Mr. Coyne, Assistant to the Board of Governors
Messrs. Keir, Kichline,[1/] and Zeisel,[1/] Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer,[1/] Adviser, Division of International Finance, Board of Governors
Mr. Kalchbrenner,[1/] Associate Adviser, Division of Research and Statistics, Board of Governors
Messrs. Peret,[1/] Taylor,[1/] and Wendel,[1/] Assistant Advisers, Division of Research and Statistics, Board of Governors
Mr. Siegman,[1/] Assistant Adviser, Division of International Finance, Board of Governors
Mr. Beeman,[1/] Chief, National Income, Labor Force and Trade Section, Division of Research and Statistics, Board of Governors
Mr. Smith,[1/] Chief, Financial Markets Section, Division of International Finance, Board of Governors
Mr. Enzler,[1/] Senior Economist, Division of Research and Statistics, Board of Governors
Mr. Annable,[1/] Economist, Division of Research and Statistics, Board of Governors
Messrs. Fleisig,[1/] Hooper,[1/] and Wilson,[1/] Economists, Division of International Finance, Board of Governors
Mrs. Cooper,[1/] Economic Assistant, Division of International Finance, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Eisenmenger, Parthemos, Jordan, and Doll, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, St. Louis, and Kansas City, respectively
Messrs. Hocter and Brandt, Vice Presidents, Federal Reserve Banks of Cleveland and Atlanta, respectively

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1/ Attended part of Monday session only; left the meeting at point indicated.

Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Mr. Ozog, Manager, Securities and Acceptances Department, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on May 20, 1975, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on April 14-15, 1975, was accepted.

Chairman Burns noted that the staff's report on the economic and financial situation at this meeting would take the form of a chart presentation. He asked Mr. Partee to begin the presentation.

Mr. Partee made the following introductory statement:

Today's presentation updates the staff's projection of the probable course of the economy through the rest of 1975 and extends it to encompass all of 1976. As usual, we approach this assignment with some trepidation. A great deal can go differently than one expects even in a brief look ahead, and the exposure is much greater when the horizon is 18 months. Moreover, there are discrete events that could occur but simply cannot be predicted. For example, we have not made allowance in our projection for the possibility of major strikes, or for another oil embargo, or for a natural gas shortage next winter that could lead to widespread industrial shutdowns, to name a few.

Nevertheless, barring major unpredictable events, the broad configuration that the economy is most likely to trace now seems reasonably clear. We have suffered a major setback in economic performance over the past 1-1/2 years, marked by the debilitating effects of generalized excessive inflation, by the distortions of the oil embargo and subsequent runup in energy costs, and finally by a sharp and pervasive economic recession. But now the recession phase of the cycle is at

or very near its end; the rate of price inflation has moderated considerably; and there is every prospect of economic recovery extending over the next 1-1/2 years or more. The question is how satisfactory that recovery is likely to be.

This is the question that will be addressed by today's presentation. In developing our base projection, which was laid out in detail in the green book,[1/] we have adopted several policy assumptions. The monetary policy assumption calls for a continuation of the present policy stance through 1976, as indexed by growth in the narrow money supply at around the 6-1/4 per cent midpoint of the range that has been announced by the Committee. We believe that this policy would result in generally rising interest rates over the forecast period, since the projected increase in nominal GNP is persistently well in excess of the money growth rate.

For fiscal policy, we have assumed expenditures for fiscal 1976 that are closely in accord with the Congressional budget resolution and $8 billion higher than projected in the Administration's midyear budget review. The difference from the Administration's estimates reflects mainly our assumption that Congress will not accept the remaining proposals for deferrals and rescissions in existing expenditure programs. We have also assumed that the temporary tax reductions applicable to 1975 incomes will be extended for 1976, which has the effect of reducing 1976 revenues by about $5 billion. In our calculations, the fiscal 1976 deficit would amount to $68 billion on an actual basis, and to about $5 billion when revenues and expenditures are converted to those that would be produced by a high employment economy.

Some assumptions are also necessary with regard to energy. For our projection, we have adopted the quite conservative view that the recent $1 increase in the oil import tax will be retained, that the OPEC cartel will raise prices by only $1 per barrel in the fall, that there will be only a small step toward decontrol of natural gas prices, and that the price of "old" domestic oil will remain frozen. Even so, the result

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

is a first-year increase in the domestic energy bill of $11 billion, most of which would represent a diversion from effective consumer buying power to receipts by foreigners, domestic energy producers, and the Government.

Given these policy assumptions, our projections for the economy are not notably more buoyant than they have been in other recent Committee briefings. We now believe that there will be no further decline in the real GNP this quarter and that substantial recovery will get under way in the quarter immediately ahead. But we see no basis for expecting that the recovery will become truly vigorous or, for that matter, that it will lose momentum during the projection period. The result is that the rate of real expansion is projected to remain quite constant,quarter by quarter--in a range of 5 to 6 per cent, annual rate--and that only a gradual down-drift in the unemployment rate can be anticipated. Further significant progress is likely on the inflation front, we believe, though the improvement is constrained somewhat by our assumption of rising energy costs.

The recovery that we are projecting is on the moderate side, but it is not the weakest one of the post-war period. Over the first six quarters, the increase in real GNP amounts to a little more than 8 per cent, which is about one percentage point more than in the 1970-71 upturn. Postwar recoveries generally have added successively less to the level of real GNP. The 1949-50 recovery was the strongest of the lot, and it was well along before the onset of the Korean War. The first six quarters of recovery in 1954-55 added about 11 per cent to the real GNP, and those in 1958-59 and 1961-62 raised real output by about 9 per cent, although the 1958-59 upswing was quite a bit stronger initially than the 1961-62 upturn. What we are projecting is close to an average of the last three cyclical experiences.

For this amount of recovery to occur, we are counting on a considerable improvement of demand in a variety of sectors. An increase in real consumption, a gradual reversal from inventory liquidation to renewed accumulation, some pickup in residential construction, and--next year--the beginnings of recovery in real fixed investment are all contained within our over-all projection. It is not an absence of generalized improvement that accounts for the moderate character of the economic recovery,

but rather the fact that none of the sectors appears likely to develop notable strength. We could be wrong in this, and yet it is hard to see the basis for exceptional vigor in any of these critically important areas of the economy.

Mr. Gramley made the following comments concerning non-financial developments:

The course of the recovery will depend importantly on developments in four critical sectors--housing, autos, inventory investment, and business fixed capital spending.

Looking first at housing, there have been signs recently of a stirring of interest on the part of both home buyers and builders. Stocks of unsold houses have begun to fall, and the number of months' supply of unsold homes has dropped quite sharply--as sales have picked up this spring. In April sales of new single-family homes were up 25 per cent--partly in response to the tax credit--and residential building permits increased by about that same amount. But despite these recent favorable developments, there is still a substantial inventory overhang in the single-family market that will act to limit new starts for a while.

In the multi-family market, the results of past over-building are less of a problem--except for condominiums, which are in ample supply. For example, the vacancy rate for rental units is not unusually high, though it has been trending up over the past several years. In the multi-family market, however, the shortage of construction financing may prove to be a factor dampening the rise in starts. The gross volume of new construction loans has fallen by more than 50 per cent in the past 2 years. This contraction was partly demand-related, but the collapse of the REIT's and the increased reluctance of commercial banks and other lenders to take on the risks of construction lending have played a role. One evidence of this risk is the rise in failures of construction firms; failures in the first quarter of 1975 were about 50 per cent higher than a year earlier.

These problems would diminish in magnitude if a strong and sustained rise in individuals' demands for new houses were to develop. An upturn in general economic activity--with improving prospects for rising real incomes and greater job security--will certainly

help to bolster home buying. Price and cost considerations, however, seem likely to act as a significant deterrent to demands for houses. For example, average prices of new single-family houses sold rose at about the same pace as the over-all CPI from 1963 to around 1970. Since then the CPI has gone up about 38 per cent, while the price of a new house--adjusted for quality changes--has gone up nearly 50 per cent. Operating costs of owning a home, moreover, have skyrocketed with sharply rising prices of fuels and electricity, and there is great uncertainty as to the future of these costs. Mortgage interest rates, meanwhile, though down from their 1974 peaks, have not returned to the levels that sustained a boom in home buying in 1971 and 1972. Overall, there appear to be persuasive reasons for expecting a recovery in housing that falls short of the previous peak level of building activity.

Turning next to autos, there are some positive factors in the outlook as well as some negative ones. On the positive side, consumer stocks of autos are relatively low now. The estimated real value of consumer stocks has been declining since mid-1973, reflecting the sharp fall-off in sales of new cars, and is now below the trend rate of increase over the past 15 years or so. Also, the ratio of instalment debt repayments to disposable income has fallen over the past year and will probably drop considerably more as growth of general economic activity and disposable income pick up.

Price considerations, however, are rather unfavorable in the auto market. For many years, the auto market has benefited from declining relative prices. For example, in 1967 the price of a new car was no higher, adjusted for quality changes, than 10 years earlier. Over-all consumer prices during this period rose by almost 20 per cent. More recently, however, new car prices as measured in the CPI have been moving up, and in some years quite rapidly. This new car price measure, moreover, understates the rise in prices faced by the consumer, who must pay for safety and pollution control equipment that BLS treats as quality improvements. Some popular makes of 1975 model U.S.-built cars, for example, presently carry list prices that are almost 50 per cent higher than comparable 1971 models.

Operating costs of cars have also risen dramatically with the increasing prices of gasoline and motor oil since the autumn of 1973. Prospective auto buyers know that these expenses will rise further, and the uncertainty as to how much prices might go up may also act strongly to deter auto purchases.

Turning next to the inventory sector, our projection implies a swing in the rate of inventory investment over the next six quarters of about $23 billion--from -0.8 per cent to about 0.6 per cent of current-dollar GNP. This swing of 1-1/2 percentage points is about equal to what we saw in the recovery from the 1960 recession, but it is smaller than what occurred in the two earlier recoveries. Given our projection of final sales, a larger rebound of inventories during the forthcoming upswing seems to us unlikely, in view of the still very high level of stocks relative to sales in real terms. Our projections of inventory investment and final sales would mean a drop to 3.3 in the ratio of business inventories to real GNP final sales, and at this level the ratio would still be approximately equal to its peak in the 1969-70 recession.

Finally, let me turn briefly to the prospects for business fixed investment. The drop in new orders for capital goods since last summer, in real terms, has been about equal to the declines of the 1953-54 and 1957-58 recessions. The decline in construction awards, however, has been considerably larger than in those two earlier recessions. Prospects for commercial building are still quite adverse, given excess capacity in office buildings and shopping centers. Also, the outlook for fixed capital expenditures by electric utilities appears rather weak now.

In our projection, we have tried to take these elements of weakness into account, while being mindful of the fact that there are strong needs for expanding investment in the materials and energy-producing industries; that pollution-control requirements may be adding another element of strength to capital expenditures; and that the investment tax credit will also be a positive factor. We do expect business fixed investment outlays, in real terms, to turn up late this year, and to strengthen over the course of 1976. Evidence available at the present time, however, suggests that the recovery in this sector will fall short of a major capital-spending boom.

Mr. Reynolds made the following comments concerning international developments:

During the past year, the U.S. merchandise trade balance and the balance on goods and services have been stronger than we had expected 6 months ago. This strength has been largely a cyclical phenomenon: the U.S. recession has been much deeper than expected, and deeper than the recession abroad, so that U.S. imports have declined more sharply than exports. Exports to less-developed countries, both oil producers and others, have been unexpectedly strong. The greater strength in exports than in imports has cushioned the decline in domestic economic activity.

Over the period ahead through 1976, we project a considerable decline in the trade balance, and a somewhat smaller decline in the balance on goods and services. This decline will also be largely cyclical. The upturn in activity abroad is expected to come a little later, and to be somewhat weaker over the projection period, than the upturn in this country. Also, demand from those less-developed countries that do not export oil is likely to be slackening in delayed reaction to the earlier decline in their export earnings, while the rapid increase in U.S. exports to OPEC countries will probably moderate. Total exports, we think, will still be an expansionary force, rising faster than U.S. GNP during 1976. But imports are projected to rise even faster.

The margin of error in these projections is, of course, very large. We are trying to estimate small balances on a gross turnover of goods and services transactions amounting to more than $300 billion annually, at a time when attitudes and policies are everywhere likely to be changing.

Our projections assume that the international value of the dollar will fluctuate around its April-May average level, which was also the average for the first 5 months of this year. If, instead, the dollar should appreciate a little, this would not greatly affect the goods and services balance over the projection period.

We have also assumed that the price of imported petroleum will be increased by a moderate amount--$1 a barrel or 9 per cent--in October 1975. Each additional

dollar per barrel would add about $3 billion to the annual import bill; with OPEC actions still undecided, the degree of uncertainty here is large.

The main factors affecting U.S. exports and imports in the short run are changes in economic activity in this country and in foreign industrial countries. The unique features of the current economic situation pose a dilemma for policy makers everywhere. On the one hand, most industrial countries are now reaching the bottom of what has been by far the longest, deepest, and most widespread recession in the postwar period. On the other hand, price inflation reached dizzy heights in 1974, and while it is now abating, inflation rates remain unacceptably high.

In this setting, monetary and fiscal authorities are almost everywhere cautious in implementing expansionary policies, and are expected to remain so. Partly as a result of this, and also because of basic structural difficulties, the recovery in economic activity over the next 18 months is expected to be only moderate. High unemployment rates and large margins of excess capacity therefore seem likely to persist.

Indeed, in the six major foreign economies combined, the margin of unused resources--already at postwar highs in most cases--is projected to increase through 1975 and into 1976. The combined growth rate for these six countries though 1976 is expected to remain below the long-term average of the past.

Germany may do somewhat better than other countries, and may begin to achieve some reduction in its unemployment rate starting in the second half of this year. But in Japan, the prospects are more uncertain. While industrial production there has apparently bottomed out, and while the inflation rate has subsided from over 20 per cent last year to around 7 per cent currently, Japanese policies are still cautious. Even allowing for the new anti-recession measures announced today, we expect that the margin of unused resources in Japan will continue to increase until late this year.

For France, the United Kingdom, Italy, and Canada, unemployment rates seem likely to continue rising into 1976, as output picks up only moderately, beginning later this year.

The projected slower expansion abroad than in this country is the main reason why we expect a slower rise

in exports than in imports over the period ahead. Also, the composition of our trade works in this direction. U.S. imports of industrial materials and of consumer goods tend to rise rather promptly with a rise in U.S. activity, whereas U.S. exports of capital goods typically lag behind a rise in foreign activity.

We do still have working in our favor, however, the broad effects of the exchange depreciation of the dollar in 1971-73. The ratio of the volume of imports to real goods GNP has leveled off since 1971, after increasing in earlier years, while the export ratio has increased sharply and is expected to rise further.

Our projections of merchandise exports are broken down into two broad classes. Nonagricultural exports, which have been declining in real terms since mid-1974, are expected to start rising again late this year and to continue rising through 1976 at a rate that, while moderate, would be somewhat faster than the rate of growth in U.S. GNP. Agricultural exports seem likely to rise a little in volume terms if crops are normal, since stocks everywhere are low. But their value, which is dropping sharply in the current quarter, is not expected to change much thereafter, as export prices decline.

Nonfuel merchandise imports are projected to turn up very soon both in volume and in value with the turn in U.S. activity, and to increase throughout the projection period. The volume of fuel imports fell off very sharply early this year and is expected to stay low through the summer. The moderate rise projected after that will bring the volume of fuel imports back only to the late 1973 level by late 1976.

The net balance on military and service transactions has shown a trend improvement in recent years. This balance was swollen by unusually large earnings from petroleum investments in 1974, and will probably decline this year, but it is expected to increase again late in 1976 as a result of a renewed rise in investment income. The level of net receipts for every major category of service transactions is now higher than in 1970-72.

When all these pieces are fitted together, the balance on all goods and services shows sharp cyclical fluctuations, as observed at the outset, but around a higher level than we had expected some 6 months ago.

Given the large current account deficits that the oil-importing countries as a group will be experiencing, our projected current account balance of plus $3 billion this year--partly for cyclically favorable reasons--and minus $4 to $5 billion next year--partly for cyclically unfavorable reasons--may be considered comparatively strong.

While there has not been time today to discuss capital flows, which have been large and volatile in both directions, we expect that such flows, together with current transactions, may be consistent with an unchanged or slightly strengthening exchange rate for the dollar.

But the world's main economic problems at this time seem to have less to do with international imbalances than with the need for recovery from recession and for continued abatement of inflation.

Mr. Kichline made the following comments on domestic financial developments:

During the past several years, the effects of inflation have worked in a variety of ways to curtail domestic economic activity. One of these ways is recorded in the behavior of the real money stock.

The stock of real money balances--nominal M_1 divided by the CPI--fell sharply from early 1973 through the first quarter of this year--reflecting rapid inflation and relatively moderate growth in nominal M_1, and is now substantially below its longer-run trend. This decline in real money stock was accompanied by a general erosion in liquidity positions, by an increased reliance on credit markets for needed finance, and by an intensification of pressures in financial markets.

In the current quarter, the real money stock will show a rise for the first time in over 2 years, and continued growth is projected through the end of 1976, given an assumed rise in M_1 averaging 6-1/4 per cent at an annual rate and a progressive slowing in the rate of advance in prices. But the growth in real money balances is appreciably less than the average increase during comparable periods of economic recovery, and the stock of money in real terms remains well below the trend path.

Another way of looking at the effects of monetary policy is to compare growth in nominal GNP with the expansion of M_1. In the first half of this year, M_1 grew somewhat more rapidly than nominal GNP, as usually happens in a recession. The decline in the income velocity of money was accompanied by substantial reductions in short-term rates of interest. Through the end of 1976, however, economic recovery will generate a rise in income velocity of typical cyclical dimensions. In the past, such an increase usually has been associated with considerable pressures on interest rates.

Our flow of funds projection tends to confirm this. In order to balance over-all demands for and supplies of funds, households will need to shift from net liquidation of securities in the first half of this year to sizable purchases by late 1976. To induce households to shift their acquisition of financial assets from deposit-type claims to market securities, interest rates will have to rise.

How much rates will have to go up is hard to say. Our estimates reflect judgmental views based on the results of our flow of funds projection as well as our econometric model. We believe that the commercial paper rate is likely to be moving up to around 8-1/4 per cent in the final quarter of this year and to perhaps 10-1/2 per cent in the fourth quarter of 1976, given the GNP projection and our monetary assumptions. Long-term interest rates would be expected to show much more moderate increases, because inflationary premiums should be declining and demands on long-term securities markets are expected to moderate somewhat from recent exceptional levels.

Financing the projected expansion in GNP will require a considerable rise in the total volume of funds raised by nonfinancial sectors. But the sectoral composition of borrowing is expected to be markedly different from that in previous years. Net borrowing by the Federal sector in 1975--at $80 billion--is huge in absolute terms and relative to total credit market flows, amounting to about 45 per cent of total funds raised or roughly twice the share of the previous peak postwar years.

Large Federal borrowings have been readily absorbed by financial markets so far this year because of the sharp recessionary drop in private credit demands. The

bulk of this reduction has been in the business and consumer sectors. But as the recovery commences, private credit needs will expand, and the combination of public and private credit demands in 1976 is projected to reach new peaks.

The magnitude of the rise in business credit demands will depend on the relation between capital expenditures (including inventories) and internal funds of nonfinancial corporations. During the recession, the external financing gap shrank because the net liquidation of inventories and the reduction of fixed investment reduced total investment expenditures much more rapidly than the reduction in internal cash flow. In the second half of this year, capital expenditures are projected to begin rising again, although the projected improvement in profits is strong enough so that the external financing gap remains moderate compared with the past few years.

Consequently, total funds raised by nonfinancial corporations are projected to rise rather gradually over the period ahead. Businesses are expected to focus their demands for funds on long-term markets, as they have in recent months, in an effort to strengthen their capital and liquidity positions.

While the restructuring of financial positions has already improved the status of many companies, there are still numerous individual firms and some industries confronting serious financial problems. For example, electric utilities have experienced a severe decline in the ratio of earnings to fixed charges--mainly interest--and also a serious erosion of liquidity. The pressures on this industry have not disappeared; investor-owned companies have found their bond ratings reduced, and rate relief continues to lag. These are important financial impediments to the participation of this industry in economic recovery.

In the consumer sector, too, financial considerations may limit the rise in spending. The real value of total financial assets held by households has declined very substantially. Rapid inflation, together with the sharp drop in stock prices in 1973 and 1974, has reduced the real value of household financial wealth to levels no greater than those prevailing a decade ago. Since late last year, real financial assets of households have again been rising, but it will take a very large increase--and probably an extended period of time--before previous peak levels are reached again.

There has also been significant improvement recently in the liquidity positions of financial institutions and in attitudes of investors. But the easing of conditions in credit markets during the recession has not yet restored previous financial positions, and market participants still remain conservative in their lending policies and quality conscious. At commercial banks, for example, the increase in liquidity positions from the low in mid-1974 has been moderate, and banks are still relying rather heavily on borrowed or interest-sensitive funds. There is probably a good distance to go before banks achieve what they view as comfortable financial positions.

The emphasis that investors give to credit quality continues to show up in the large risk premiums attached to borrowings of lower-rated companies, and thus to the spread between Baa and Aaa bonds. Although the flow of investor funds into lower-grade bond and commercial paper issues has increased somewhat in recent months, risk premiums are still large, and some firms have not found receptive markets.

Considerations such as these suggest that financial market developments in the period ahead are not likely to be an influence conducive to an unusually vigorous recovery. The most important channel through which credit restraint will dampen recovery, however, will probably continue to be the effects of rising market interest rates on savings flows and the markets for housing finance.

At savings and loan associations, in the absence of a change in interest rate ceilings, rates on savings accounts and certificates will become less attractive relative to rates on market securities as the latter move higher, and this is expected to result in a decline in growth of deposits at S&L's to about 7 per cent, at annual rates, by the latter part of 1976. This is a much better performance, given market interest rates, than in previous periods of disintermediation, in part because of the restrictive withdrawal penalties attached to the sizable volume of time certificates at S&L's. Even so, our projections suggest that by late 1976, credit restraint will be adding to nonfinancial factors in limiting the recovery in housing.

Mr. Zeisel made the following comments concerning wages and prices:

The recovery in real GNP projected for the next year and a half seems likely to provide margin for only a modest improvement in the labor market. We are projecting a gain in total jobs of close to 2-1/2 million over the next six quarters. This would bring the employment total about back to its pre-recession peak in the summer of 1974. But the labor force is also projected to continue to increase substantially during this period. As a result, we expect the unemployment rate to fall from the current 9.2 per cent to only around 8-1/2 per cent by the end of 1976--a very high jobless rate by postwar standards.

Continuation of sizable gains in the labor force is a major reason for the poor performance of unemployment expected in the period ahead. Over the long term, labor force growth has tended to parallel the increase in the working age population fairly closely. In effect, the over-all participation rate has remained relatively stable, the result of a balance between increases in participation among adult women and declines among older males and teenagers. But beginning about 1973, growth in labor force accelerated, probably largely reflecting the pressure of high and rising consumer prices, which influenced wives and other family members to seek jobs to supplement family incomes. These pressures have apparently continued to be an important factor underlying the unusually rapid labor force growth in recent months.

But characteristically, participation rates do tend to decline in periods of high unemployment--and we expect this phenomenon to occur in the period immediately ahead. Thus, we are projecting labor force growth to slow during the remainder of this year, and in 1976 the total is projected to increase by about 1-1/2 million--just about equal to the growth rate of the population of working age.

The response of employment and unemployment will also depend on the course of productivity gains. As you know, periods of declining output tend to be associated with below-average productivity growth--or sometimes sizable outright declines, as happened

recently. But these shortfalls historically have been made up by an acceleration of growth in the early recovery phase of the cycle, when output increases rapidly. Since the strength of the rebound in productivity tends to be positively correlated with the rate of growth in real output, we expect that the moderate recovery projected for real GNP will be associated with a commensurately moderate rebound in productivity. Thus, the annual rate of increase in output per manhour is expected to average about 3 per cent over the next six quarters, only slightly better than the long-term average.

This may be a conservative projection of productivity gains. More rapid improvement would certainly be desirable from the standpoint of greater stability in costs and prices, but it would probably also be associated with still higher unemployment in the short term than we now foresee.

Turning to wages, it is evident that we have already experienced a substantial moderation in the rate of increase over the past year, a function of both increased slack in the labor market and the easing of price pressures. The average hourly earnings index for private nonfarm workers has risen at about a 7 per cent annual rate so far this year, as compared to the double-digit rates of last summer. However, we expect only limited further progress in reducing the rate of wage gain over the next year and a half.

True, continued high unemployment should restrain wage pressures, particularly in the less organized sectors, and the slower rate of inflation will help to hold down wages in the more highly organized sectors, particularly in those industries which have cost-of-living clauses. But 1976 brings another major round of collective bargaining, and the sharp erosion of real spendable earnings over the past 2-1/2 years seems bound to continue to provoke demands for substantial pay increases. As the pace of the price rise moderates further and the workweek begins to recover, we should see a bottoming-out of the earnings index, which in time should ease pressures on wage demands.

For unions with strong bargaining power, however, we might expect, as a rule of thumb, an attempt to achieve a catch-up wage adjustment to compensate for increases in the cost of living plus about a 3 per cent

productivity factor, and some front loading. As an illustration, in trucking--where the contract runs out next March--the existing agreement has compensated for only a small portion of the recent inflation, and the first-year increase could well be over 10 per cent. In autos--where the contract runs out in September 1976--the cost-of-living clause has more effectively kept wage increases in line with prices, and the first-year wage increase might be held to the 7 to 8 per cent range. Of course, for less well organized and less powerful labor sectors, wage increases are likely to fall below these rates.

Our forecast of compensation per manhour takes these factors into account, along with the increases scheduled to take effect next January 1 in the minimum wage and in the social security tax base. On average, we foresee a gradual moderation from the 8-1/2 per cent annual rate of increase of the first half of this year to about a 6-1/2 per cent rate toward the end of 1976. With productivity also improving, the rise in nonfarm unit labor costs is projected to fall to about a 4 per cent rate for most of 1976, down from a 14 per cent rate during the four quarters of 1974.

We are projecting a generally close correspondence between changes in unit labor costs and prices. Food and materials prices--which contributed so much to inflation in the past few years--are now expected to play a minor role over the next year and a half, with the exception of the anticipated rise in energy prices. Evidence available at this time does not suggest much likelihood of upward pressure on food prices from the supply side. For materials, also, swings of a magnitude likely to have a substantial impact on the general price level do not seem probable, given the moderate recovery projected for activity both here and abroad.

On balance, therefore, we expect over-all prices to move generally in line with labor costs, with the increase in the gross private-product, fixed-weighted index expected to slow further to about a 6 per cent annual rate in the second half of this year, and to a bit over a 4-1/2 per cent annual rate by late next year. These projections include the effects of the assumed increases in the price of energy, which contribute close to half a percentage point to the rate of price rise in the second half of this year, and add about 0.7 per cent to the general price level by the end of 1976.

Mr. Partee made the following concluding remarks:

The evidence we have reviewed today, it seems to me, all supports the view that the coming economic recovery will be on the moderate side. The prospects for housing, for auto sales, and for capital investment--though all improving--do not seem sufficiently strong to support boom levels of activity in these areas. Business inventories remain relatively high in physical terms, which would seem to limit the room for a renewed inventory build-up on any really substantial scale. Nor does the possibility of strong stimulus in our foreign trade sector look like a very good bet, given the cyclical configuration of the world's major economies, the oppressive continuing burden of meeting the bill for foreign oil, and the availability of ample unused productive capacity and labor resources almost everywhere.

A receding rate of inflation does promise relief to the hard-pressed consumer, and this could conceivably spark more of a resurgence of optimism and of spending--once a recovery is under way--than we have allowed for. Continued moderation in the inflation rate will also be helpful in holding down long-term interest rates and should work to improve attitudes in financial markets generally. But financial factors do not appear particularly promising. Lenders continue very selective in risk-taking and there will continue to be an ample volume of Government and other high-grade securities to buy. Altogether, I find it hard to question the conclusion that this recovery has less going for it than ordinarily has been the case in the past.

It is true that economists often tend to understate the dimensions of recovery because they fail to see the new, dynamic sources of strength that will emerge. We tried explicitly to allow for this bias by reviewing our projection record during the last recovery to see how much we had underestimated the strengths developing at that time.

We did understate the rise in real GNP in both 1971 and 1972, judging from our November projections of the prior year. But the difference in projected versus actual growth was not large--about 1-1/2 percentage points in the course of 1971 and a little over a point in 1972. In both cases, a more expansive course of policy than we had assumed helped to account

for the shortfall. In November 1970 we could not have foreseen the new economic program launched the following August, which gave new vigor to the economic expansion. And in November 1971, our projection for the following year assumed continuation of 6 per cent growth in the narrow money supply, whereas the actual growth rate turned out to be substantially higher.

If one accepts the conclusion that the economic recovery is likely to prove moderate, the question arises as to what could or should be done to attempt to invigorate it. First, we believe that there is room for a more rapid expansion, given the idle resources that exist at present, without running the danger of any significant heightening of inflationary pressures. For labor markets, the continuation of an unemployment rate in excess of 8 per cent makes it clear that there are ample human resources to permit greater real output. To test the hypothesis in the case of industrial capacity, we considered the projected course of the industrial production index in relation to its trend growth over the past quarter of a century. In the fourth quarter of 1976 the projected index is still 12-1/2 per cent below trend, which is as large a gap as existed at the low point of most previous postwar recessions. Although such a comparison does not provide direct evidence as to the availability of usable capacity, the large shortfall does suggest that there should be considerable latitude for a stronger industrial recovery.

Also, we attempted to measure the relative contribution of the Government economic policies that we had assumed in helping to stimulate economic expansion. Growth in the real money stock, though a potentially misleading guide to policy in periods of excess demand, would--under present conditions--seem to provide a meaningful measure of additions to real liquidity; growth turns positive and remains so throughout the projection period. However, the rate of increase in real money is projected to be below the average of the 1961-68 period and also below the rates that financed earlier recoveries. Similarly, the high employment budget, though projected to remain somewhat on the stimulative side, is a good deal less so than in some earlier periods.

Accordingly, we decided to estimate the effects over the projection period of a more stimulative economic

policy package. An additional $15 billion of fiscal stimulus was assumed for calendar 1976, made up of another tax rebate next spring and of $7 billion in additional Federal outlays that include special expenditures of about $2-1/2 billion for another bonus to social security recipients or similar low-income groups and a moderate sustained increase in Federal purchases associated with public works or other spending programs. We also assumed that monetary policy would be somewhat more expansive beginning in the second half of this year, as indexed by M_1 growth from that point at a 7-1/2 per cent rate.

Given these policy assumptions, we would expect somewhat stronger growth in real GNP throughout, but particularly in the spring and summer of next year where the additional fiscal stimulus is concentrated, and then some moderation in the rate of expansion as the fiscal effect wanes. For the six quarters combined, the average growth rate might be on the order of 7 per cent--1-1/2 points higher than in the base projection. As a result, the unemployment rate would decline more rapidly, dropping by about a full point during 1976 to slightly under 8 per cent in the final months of that year. We believe that there would be very little effect on the rate of inflation over the projection period with the fixed-weighted deflator rising at around a 5 per cent pace in the second half of 1976, though there probably would be somewhat more impact on the price level later on. Our econometric model indicates that the level of prices in the alternative policy assumption would be on the order of three-fourths of one per cent higher than in our base projections by the end of 1977.

I might add that we would not expect the level or pattern of interest rate changes to be greatly different in the alternative projections. The somewhat greater sustained rate of monetary growth just about offsets the effects of the larger Federal deficit and increased gross national product in the more stimulative variant. Nor, for that matter, would the actual Federal deficit turn out to be anything like $15 billion higher, since the larger GNP generates additional tax revenue. The indicated net effect would be to raise the deficit by about $6 billion, to a total for calendar 1976 of $70 billion.

Chairman Burns commented that, as he had suggested at the previous meeting, it would be desirable if Committee members' comments on the economic situation and outlook emphasized any points on which they differed significantly from the staff analysis.

Mr. Mitchell referred to the statement in the staff presentation to the effect that interest rates would have to rise in order to induce households to shift their acquisition of financial assets from deposit-type claims to market securities. He asked if it would not be better to modify the financial structure in a way that encouraged the depository institutions to broaden the investment alternatives that they made available to the household sector.

Mr. Kichline replied that in making its projections the staff had assumed that the financial structure and interest rate ceilings on certain types of deposits would be unchanged. Under those circumstances, the flow of funds into consumer-type deposits would fall as interest rates rose. Moreover, the nonbank thrift institutions--particularly the savings and loan associations--would continue to be limited in the investment outlets available to them.

Mr. Mitchell said he was disturbed by the high level of interest rates expected to be associated with the projected levels of real GNP. If that was the result of some quirk in the

institutional environment, then means should be sought to change that environment.

Mr. Gramley commented that the switch in household purchases of financial assets from deposits to market securities was a function of interest rate differentials. If Regulation Q ceilings were raised as market interest rates rose, households would continue to buy deposit-type claims and the nonbank thrift institutions would remain active, but the level of market interest rates would be as high as otherwise.

Chairman Burns observed with respect to the staff projections that he had learned from many years of experience that it was extremely difficult for economic forecasters to take account of the momentum which tended to develop in a private enterprise economy once a recovery got under way. He would stress that point even more than Mr. Partee had in his concluding remarks. Secondly, he was less optimistic about the prospective behavior of prices than the staff appeared to be. Since the beginning of the year prices of sensitive raw materials had been rising--gently but definitely. It was normal cyclical experience for a general rise in prices to get under way first in the market for sensitive raw materials, then to fan out to wholesale markets more broadly,

and after about a year or a year and a half to be reflected in the behavior of consumer prices. Finally--and he did not mean this as a criticism of the presentation--he tended to think of Governmental policy more broadly than in terms of monetary and fiscal policies alone.

With respect to his final comment, the Chairman said, one might ask whether there were other things the Government could do to stimulate the economy if monetary and fiscal policies were held on a steady course. In his view, there were, and he would suggest just a few possibilities. The automobile industry had been subjected to some onerous and costly requirements to reduce pollution and improve safety. If those requirements were relaxed, a major factor that had been driving automobile prices upward would be removed. Secondly, a great deal of highway and electric utility plant construction had been held up by the need to file environmental-impact statements. If the Congress dealt with that problem, he believed that spending would be activated on many projects already planned.

In the labor market area, the Chairman continued, the Congress could take actions that would have considerable impact, although it undoubtedly would be reluctant to do so. For many years, teenagers had been priced out of the labor market;

a serious problem of teenage unemployment existed today--whereas none had existed during the 1940's--because teenagers' labor had become over-priced relative to its productivity. The same situation had developed in Russia. In Japan, on the other hand, teenage labor was under-priced relative to productivity, and the demand for such labor consistently exceeded the supply; there was no teenage unemployment in Japan.

In the construction industry in this country, the Chairman noted, the unemployment rate was above 20 per cent, and yet wages were continuing to rise--sharply in some areas, such as the Pacific Coast. Suspension of the Bacon-Davis Act--which could be accomplished by Executive Order--could help enormously. Beyond that the Congress could pass legislation declaring illegal all contracts that called for hiring only through the trade union hall, although he did not see any such legislation coming quickly. Finally, organization of "job banks" on a comprehensive scale could eliminate a great deal of the unemployment existing today. He was greatly interested in job banks, and some years ago he had been responsible for stimulating interest in the subject within the Government. However, not much had been done.

His point, the Chairman remarked, was that in relying exclusively on fiscal and monetary stimuli, the Government

was using policies that had great inflationary potential. In contrast, measures of the sort he had mentioned--and the list could be lengthened considerably--could stimulate the economy with much less, if any, inflationary effect.

Mr. Morris observed that one basic issue the Committee had to grapple with was the economic growth path for the next 5 years that might be optimum in the sense of being compatible with continued diminution in the rate of inflation. In light of the earlier postwar recoveries that had been mentioned in the staff presentation, the 5-1/2 per cent growth projected by the staff for the first year of the present recovery was likely to be below the optimum growth path, although he could not judge by how much. For the next two quarters, the projected rate of expansion was only slightly higher than growth in the first two quarters of the 1970-71 recovery, and in view of the much larger amount of idle resources at present, the projected recovery would in a sense be the most sluggish of the postwar period. To equal the average gain in earlier postwar recoveries, real GNP would have to expand by 7 or 8 per cent over the next four quarters. The question in his mind was whether expansion at that pace would put the economy on a track that would create difficulties in containing inflationary pressures in the years

beyond the forecast period. He would be interested in the staff's view of the optimum rate of growth that might be compatible with a continuing downward drift in the rate of inflation.

In response, Mr. Partee noted that on the basis of the assumptions of the alternative policy package outlined in the staff presentation today, real GNP would grow at a 7 per cent annual rate over the next six quarters. The faster rate of growth did not by any means use up all the idle resources available, and it did not raise the price indexes very much--although the effect on the price level probably would be somewhat greater in the year beyond the forecast period. Thus, the level of average prices at the end of the forecast period would be higher by something under one per cent if the rate of growth in real GNP were 7 per cent rather than 5-1/2 per cent. He considered the trade-off to be quite favorable; a lot more improvement in the unemployment situation would be achieved at a relatively small cost in terms of a higher level of prices. He thought the trade-off would still be favorable with an 8 per cent rate of growth in real GNP, but a 9 per cent rate of growth was questionable and a 10 per cent rate probably was too high. He would like to see

real growth at an 8 per cent rate for the next year and a half and would not mind a 9 per cent rate.

Chairman Burns remarked that he thought Mr. Morris' emphasis on the longer term was tremendously important, and he hoped that Committee members would bear it in mind when the time came to discuss today's policy decision. If anything like general price stability was to be achieved in this country, monetary growth rates would have to be reduced gradually; there was no other way of achieving that objective. He believed that Mr. Partee's answer to Mr. Morris' question was on an abstract plane, because the particular means of achieving a higher rate of growth in real output--whether 8, 9, or 10 per cent--would influence the outcome.

Mr. Partee said he agreed that the means made a difference. If the higher rate of growth was accomplished with a faster rate of monetary expansion early in the recovery period, the rate of inflation would not necessarily be raised, provided that monetary expansion was slowed down in time. However, that might be difficult to achieve. With respect to fiscal policy, he believed that any stimulative measures should be temporary. Nevertheless, he would prefer to aim for an 8 to 9 per cent rate of real growth over the next year and a half.

Mr. Gramley observed that he was substantially in agreement with Mr. Partee's view. The model had not been used to assess how high the rate of growth in real GNP could be pushed before arriving at the point where the rate of inflation flattened out and was no longer declining, but from what had been done, he would judge that 8 to 9 per cent was about as high as the rate of real GNP growth could be raised.

Mr. Morris remarked that longer-term projections would provide useful perspective for policy deliberations, even granting the limitations of the model. Policy for the coming year should be determined in the light of the dynamics of the economic process over the next 4 or 5 years, to the extent they could be assessed. At this particular time, the projection period through 1976 was not really long enough.

Mr. Partee commented that the econometric model had been used to project developments through the first quarter of 1978, but he was extremely hesitant to make projections even that far ahead. The further out the projections extended, the more the assumptions built into the model appeared as the results. While he agreed that it would be useful to have longer-term developments in mind, he did not believe that sensible projections could be produced with the existing techniques.

Mr. Wallich observed that a critical question was whether inflationary pressures would be eliminated in this period of recession and recovery or whether the economy would move into a new expansion with prices still increasing at a rapid rate. Viewing the staff projection, he was distressed by how little reduction in the inflation rate appeared to be in prospect despite high unemployment. That prospect suggested that growth in real GNP could not be stepped up much from the rate in the staff projections without a renewal of inflationary pressures. Businessmen in general seemed to expect that inflation in the period ahead would exceed a rate of 6 or 7 per cent. He thought that would become a realistic expectation if real GNP grew at an 8 per cent rate for more than a quarter or two, and he wondered why the staff believed that such rapid growth for a number of quarters would be consistent with continued reduction in the rate of inflation.

Mr. Partee commented that it was difficult to say whether or not it might be consistent. The rate of price increase projected for the fourth quarter of 1976 was still as high as 4-1/2 per cent, despite a high unemployment rate in the intervening period, for a number of reasons: food prices were likely to rise by 3 per cent or more, on the assumption of normal harvests;

energy prices would increase further, adding at least a half of a percentage point to the deflator over the projection period; and demands for wage increases would be influenced by efforts to make up for past increases in prices.

Mr. Wallich remarked that the special factors affecting prices made the trade-off between inflation and growth worse now than it would otherwise be. Consequently, the price effects of an 8 per cent rate of growth for a number of quarters would not be tolerable, even if one could demonstrate that they would be tolerable under more normal conditions.

Mr. Partee observed that capacity utilization was so low and unemployment so high that levels of output in general could be raised considerably without adding to the rate of increase in prices. Improvement in the labor market might enlarge some wage demands, but productivity would improve more rapidly in the short run and the rise in unit labor costs was likely to be smaller with a sharp recovery in output than with a more moderate one. Consequently, while the inflation-unemployment trade-off had become worse, he would not agree that it had become so much worse as to preclude an effort to reduce the unemployment rate below 8 per cent--or even below 7 or 6 per cent.

Chairman Burns said he might note one ominous development relating to prices to which the Government, unfortunately, was giving some encouragement. He had in mind the growing pressure for cartels in various raw materials and foodstuffs. While such cartels were urged as a means of stabilizing prices, they no doubt were also intended to make prices higher than they otherwise would be.

Mr. Holland said he believed the staff's projections for prices were not consistent with those for interest rates. If the rate of price rise should slow as much as projected, it would be sufficiently below the rate generally expected by businessmen and financial market participants to alter many business decisions and to reduce the inflation premium in interest rates. On balance that outcome would make the Committee's task a little less difficult. It also would mean that businessmen would find their costs behaving better than they had expected. In that kind of atmosphere, moreover, businessmen might well be motivated to achieve additional economies--other than the conventional kind affecting unit labor costs--to raise profit margins. His expectations were only intuitive, but they influenced his thinking on policy, and he would be watching actual developments carefully.

Mr. Francis remarked that the staff projection seemed to be consistent with the underlying assumptions, and the assumptions appeared reasonable to him. In his judgment, however, the projection implied that the use of more fiscal stimulus and faster monetary expansion to raise the growth rate of real GNP to 8 per cent would risk a substantial escalation in the rate of price rise. The present situation with respect to the structure of the labor force and unemployment differed from earlier experience, and he thought it would be necessary to accept higher levels of unemployment than anyone would like to see. In particular, policymakers would have to focus more on labor force participation rates and on the number of people employed than on the unemployment rate if they were going to put the economy back on track without increasing inflationary pressures.

Chairman Burns recalled that the ratio of total employment to the number of persons in the population who were 16 years of age and over in the first quarter of this year was almost the same as the ratio in the fourth quarter of 1965, and yet the unemployment rate was more than 8 per cent in the later period compared with about 4 per cent in the earlier period. Obviously, the labor force participation rate had increased considerably, and it would be a mistake to concentrate attention exclusively on the unemployment rate.

Mr. Balles observed that his own view of the economic outlook was very close to that presented by the staff. He was concerned that if interest rates rose as much as suggested by the staff projection, the financing of housing and of State and local government expenditures would be adversely affected and the expansion in those sectors might be significantly dampened. In that light, he asked whether the staff had developed any opinion with respect to the hypothesis that the financing of a Federal deficit beyond some critical level, given the assumed rate of monetary growth, would cause private demands for credit to be crowded out of the market.

Mr. Partee replied that he would prefer to say simply that a rather large volume of funds would be raised in the period through the end of 1976. It was true that the substantial Federal deficit in prospect would make a significant contribution to that total. In his judgment, however, the important point was the total volume of funds to be raised, rather than the distribution between the Government and the private sector. He might add that a basic premise in the projections was that the change in short-term interest rates was a function of the relationship between growth in the money stock and growth in nominal GNP. Over the projection period, nominal GNP was projected to rise substantially more than M_1 and slightly more than M_2, providing the basis for projecting higher interest rates.

In the more stimulative policy alternative, Mr. Partee continued, both the rate of monetary growth and the level of the Federal deficit had been raised. Consequently, the pattern of interest rates in the alternative projection was just about the same as in the base projection.

Mr. Winn asked what the projection implied for the behavior of stock prices.

Mr. Partee replied that stock prices were thought likely to rise considerably over the projection period. On average, stock prices were relatively low at present.

Mr. Mayo remarked that if he had any criticism of the staff presentation--which he thought had been excellent--it was that the alternative policy considered by the staff was timid. If the unemployment rate should be around 9 per cent toward the end of this year, political pressures were likely to bring about additional fiscal stimulus in 1976 that would be two or three times the $15 billion in the staff's alternative. He would guess that the impact on output, the unemployment rate, and prices would be more than two or three times the difference between the staff's base and alternative projections.

In response, Mr. Partee noted that apart from the extra $15 billion of fiscal stimulus included in the alternative projection, both the base and alternative projections allowed for

the extension through 1976 of the 1975 income tax reduction, which was not part of the Administration's program. The staff had not considered a still more stimulative fiscal policy because of the Administration's strong resistance to a sizable increase in the deficit. The staff's alternative assumptions represented the kind of compromise that might actually be worked out. What would develop in the event of a considerably more stimulative policy would depend on whether or not monetary policy was accommodative. If monetary policy should be the same as in the staff's assumptions, interest rates would rise more and some activities--such as housing--would be adversely affected. If monetary policy were more accommodative, prices might rise at a substantially faster rate out beyond the projection period. He thought that when the average investor or the average businessman spoke of a return to a high rate of inflation even though the rate was falling now, he had in mind a politically induced combination of a considerably more stimulative fiscal policy and an accommodative monetary policy.

In response to another question by Mr. Mayo, Mr. Partee observed that in the alternative as compared with the base projection, the Treasury bill rate would be somewhat lower in the early part of the projection period but it would be about the same by the end of 1976.

Mr. Eastburn said that the staff projections appeared to imply a rise in the income velocity of money that was about average for a period of economic recovery. If the assumed increase in velocity over the projection period equaled the fastest rise that had occurred in a postwar period of recovery, according to an analysis by the Philadelphia staff, the unemployment rate would be reduced only by about one-half of a percentage point from the green book forecast. Therefore, the Committee should be wary of the argument that money stock growth should be lower during a recovery because of a rise in velocity. A rise in velocity was already built into GNP forecasts. He would continue to emphasize the money stock during recovery as in other phases of the business cycle, especially in light of the high rate of unemployment.

Mr. Gramley commented that the increase in velocity over the six quarters ending in the fourth quarter of 1976--at an annual rate of about 4.5 per cent--was roughly in line with experience in most postwar recoveries; the annual rate of rise in the first six quarters of recovery was 5.7 per cent in 1954-56, 4.8 per cent in 1958-59, 5.7 per cent in 1961-62, and 3.1 per cent in 1971-72. The projected increases in interest rates also were consistent with past cyclical experience. He would note that the figure of 4.5 per cent for the period ahead was not an assumption but rather was a product of the judgmental

projection. He did not believe that one could make assumptions about velocity that were independent of the projections for various categories of spending.

Mr. Wallich observed that preliminary results of some work that had been done for him suggested that velocity was a function of income and of wealth as well as of interest rates; after those factors were accounted for, a slight trend remained, which might be attributable to technological change. The regressions--which were done in a way that reflected the rise in income rather than the level--indicated that the significant rise in velocity that occurred in the early phase of expansion, when interest rates were moving up, was accounted for by those factors. One should not expect velocity to rise without some rise in interest rates.

Mr. Baughman commented that the businessmen with whom he talked still firmly held the view that the inflation problem would not be dealt with adequately and that after a year or so inflationary pressures would be strong once again. They would consider those expectations to be confirmed if more expansive fiscal and monetary policies were pursued. He wondered whether such attitudes would be likely to have much effect on actual developments. With respect to short-term interest rates, he asked

about the extent to which the projected rise was influenced by the projection of an increase in economic activity. In light of the under-utilization of resources over the projection period, the rise in short-term rates seemed large.

In response, Mr. Partee commented that expectations based on observed policy developments--unless of an extreme character--would probably have little impact on economic activity, although they could affect long-term interest rates. Concerning the interest rate projections, the extent of the rise reflected a residual rate of inflation that contributed to a 12-1/2 per cent annual rate of growth in nominal GNP over the second half of this year.

Mr. Gramley added that the interest rates projected were believed to be consistent with the projected rates of growth in the money stock and in nominal GNP. There were, of course, many uncertainties; the present situation was unlike any experienced before. If prices rose at the projected rate, expansion in real GNP might well fall short of the projected rate. Questions could also be raised about the consistency of the projections for prices and corporate profits. However, he believed that the staff had put together a consistent projection.

Mr. Black said he believed that developments in other major countries had to be taken into account in considering the likely course of interest rates. Prospective developments abroad, as presented by the staff, suggested that policies would be eased progressively in major countries, with the possible exception of the United Kingdom, and because economies and financial markets were so highly integrated, interest rates might well decline on a world-wide basis. He asked to what extent the staff had taken such international influences into account in making its projection.

Mr. Reynolds commented that the staff had not made explicit assumptions about the course of interest rates abroad. Rates had been coming down in other major countries--in recent months, more rapidly than in this country--but he would not expect them to decline much further, even if recovery in activity should prove to be quite slow. It appeared that the foreign authorities were too worried about inflation to push interest rates much lower. If interest rates in this country advanced in accordance with the projection, they were likely to rise somewhat relative to those abroad. That would tend to strengthen the exchange value of the dollar.

Chairman Burns remarked that in recent conversations with central bank governors in Basle, he had detected intentions to try to hold interest rates where they were for a while. He thought it unlikely that rates at the central bank level would decline further.

Mr. Kimbrel asked whether there was some particular reason to expect real GNP to grow at a rather stable rate over the next six quarters, as projected by the staff.

In reply, Mr. Partee observed that he had initially been surprised to find such stability in the projections, because it was not usual in the real world. The projections were relatively flat because dramatic strength did not appear to be in prospect for any sector of the economy; it was not expected, for example, that auto sales would rebound to an 11 million annual rate next winter or that housing starts would surge temporarily to an annual rate of over 2 million. It was likely that there would in fact be greater fluctuations than the projections indicated, for such reasons as strikes or widespread plant shutdowns due to energy shortages.

Chairman Burns commented that he had seen alarming forecasts of shortages of natural gas in different parts of the country over the next 6 to 12 months, which suggested that some production facilities might indeed have to shut down. Monetary

and fiscal policies could do nothing about that sort of problem. That was just one situation among many that led him to believe that excessive attention was focused on the conventional policy tools.

Mr. Coldwell asked whether the staff had assumed any front-loading in the rate of monetary growth over the projection period.

Mr. Partee replied that no front-loading had been assumed in either the base or the alternative projection, except for that reflecting growth in M_1 in the second quarter of this year at an estimated annual rate of about 9 per cent. The staff believed that it would be so difficult to accelerate the rate of monetary growth and then to slow it sharply that it did not consider that to be a likely policy course.

Mr. Gramley added that earlier the staff had done simulations of the econometric model in order to explore the effects of short-run deviations from a longer-run monetary growth path. A 6-month rate above the longer-run path offset by a subsequent 6-month rate below the path would have minimal effect on growth in real GNP. However, such a pattern would produce gyrations in financial markets; in the period ahead, it would hold down the rise in interest rates for a while and accelerate it later on.

Mr. Holland observed that it seemed desirable to have on the record the view that the Committee regarded the unemployment rate projected throughout 1976 as unsatisfactorily high--that it was not being accepted as a target--and that a rise in the GNP deflator at a rate of 6 per cent or more also was unsatisfactory. If the projections were correct, there was not much room for improvement in the performance of the economy through policies that directly stimulated aggregate demand. The main job of reducing the unemployment rate below the projected levels had to be done by programs that lowered the supply schedule of the economy and increased its elasticity; included were structural policies as well as business programs to reduce costs. If price performance proved to be better than projected, there might be some additional scope for stimulative policies, and evidence would become available month by month on just how much scope there was.

Mr. Wallich remarked that he shared Mr. Holland's view. However, he was not very hopeful that much would be accomplished along those lines. If it appeared that the country was condemned to have either inflation or high unemployment, incomes policies might have to be contemplated once again. Experience had shown that such policies were successful in holding down prices and wages for only a short time before they began to

break down, and that they eventually exploded or were abandoned. However, more market-oriented schemes that functioned through the tax system might be used. For instance, a tax might be levied on excess wage increases. Or some kind of agreement might be negotiated under which business accepted a limitation on the share of corporate profits in the national income and labor accepted some kind of a ceiling on wages; the former would be protected against excess wage demands and the latter against excess profits. And if one believed that the rate of inflation would decline over an extended period, a case could be made for indexing--even though he had always opposed indexing as an explosive influence on the behavior of prices. If it should be clear that the inflation rate was declining, however, indexing would tend to accelerate the downward movement.

Mr. Mitchell observed that in his opinion the discussion of structural changes in the economy had an air of unreality; Chairman Burns was the only System official whose suggestions would carry any weight. The Committee had to take the world as it was. Concerning the staff projection, he neither liked it nor fully accepted it. The projected price performance was quite good, but the unemployment rate was too high. He was skeptical about the amount of rise projected in business investment, and even more skeptical about the projected rise in housing in an environment of such high interest rates, unless people assumed that the rate of inflation was going to rise again.

In response, Mr. Partee said interest rates did not reach such high levels until the end of the projection period and, therefore, would not exert an adverse effect on housing in the interim. He would agree that the rather good recovery indicated for each sector of the economy was a little difficult to accept, but there was evidence that housing activity was beginning to move up and that funds were beginning to flow into mortgages. If mortgage interest rates did not rise sharply in the next 6 to 9 months, there would be a moderate recovery in housing, and the projection did not suggest any more than that.

Mr. Gramley commented that sales of new single-family houses had risen around 50 per cent from the low of last December. The market was no longer frozen.

Mr. Mitchell remarked that in his opinion the rise was temporary, that it reflected purchases by people who had strong needs but who had not been able to get into the market until recently. The housing industry had managed to price itself out of the market.

At this point the following left the meeting: Messrs. Allison, Keir, Kichline, Zeisel, Pizer, Kalchbrenner, Peret, Taylor, Wendel, Siegman, Beeman, Smith, Enzler, Annable, Fleisig, Hooper, and Wilson, and Mrs. Cooper.

Chairman Burns then suggested that the Committee discuss the question of its 12-month targets for ranges of growth rates in the monetary aggregates. He might note that he had struggled with the technical issue of the particular 12-month period for which it would be appropriate to express targets at this time. The targets which the Committee had adopted at its April meeting and which he had reported to the Senate Banking Committee in his May 1 testimony related to the interval from March 1975 to March 1976. He had been inclined initially to recommend that the Committee employ the same period for the targets it formulated today--which, unless modified at the July meeting, would be those reported in his testimony before the House Banking Committee scheduled for July 24. Under that procedure, about 9 months of the target period would be in the future. While a literal reading of the Concurrent Resolution, which referred to ranges of growth "in the upcoming twelve months," would suggest that the period for which targets were to be reported to Congress should be the 12 months ahead, the legislative history of the Resolution indicated that either method of reporting could be deemed appropriate. However, in a recent conversation with Messrs. Rippey and Cardon, the Board's present and previous assistants for Congressional liaison, he

had found that they both were definitely of the view that it would be a mistake to report targets for a 9-month period to the House Committee after having reported 12-month targets to the Senate Committee. He could go along with either method of reporting, particularly since he thought the difference was without significant meaning. However, in light of the views of Messrs. Rippey and Cardon, he was now inclined to suggest that the language of the Concurrent Resolution be taken literally and that target ranges for the 12 months ahead be provided regularly in quarterly testimony under the Concurrent Resolution.

Mr. Morris commented that if the Committee adopted that procedure and occasionally changed its targets the picture could get quite complicated.

Mr. Mayo remarked that his own thinking about reporting under the Concurrent Resolution had tended to run in terms of a moving target--that is, reporting each quarter on the objectives of monetary policy for the period then lying 12 months ahead--as the Chairman had suggested. He thought such a procedure would be more realistic than that of retaining the same calendar period in successive reports to Congress, and thereby permitting the part of the period still lying ahead to shorten progressively.

The Chairman observed that there were advantages and disadvantages to both methods. If one was concerned about

accountability, the use of ranges for shifting time periods could result in some confusion. In any event, the Committee had to live in a new environment, and on balance he thought it might be best to think now in terms of ranges of desired growth rates for the aggregates for the interval from June 1975 to June 1976. As to the particular targets to be adopted, he would recommend that the ranges previously agreed upon be retained. Those ranges had been announced only recently and he was pleased that their reception had been preponderantly favorable in Congress and among financial journalists and business people. Moreover, those ranges were sufficiently broad to provide the leeway the Committee might need.

Mr. Mitchell said he favored retaining the present ranges; having gone through the ordeal of announcing longer-term targets for the first time only 6 weeks ago, it seemed to him that there was no point in changing them at this juncture. For the time period, he could accept intervals ending in either 9 or 12 months. However, he would not want to be obligated to use periods extending one year into the future each time the Committee adopted longer-term targets; there might be occasions when the Committee would not want to project out further than 9 or even 6 months.

Chairman Burns remarked that, while the Committee had some flexibility with respect to time periods under the Concurrent Resolution, he thought a 6-month target period would not be responsive to the Resolution.

Mr. Holland observed that the 12-month growth ranges shown under alternative B in the current blue book[1/] were similar to those previously adopted. The alternative B range for M_1 was identical to the previous range, and those for M_2 and M_3 had been lowered somewhat. If the Committee adopted the alternative B range for M_1 he would prefer not to modify the ranges for the other aggregates as yet; it would be better to await further evidence before concluding that the outlook for inflows at thrift institutions, for example, had weakened.

Chairman Burns remarked that he had given some thought to the best means of adjusting the growth ranges at the time when the Committee wanted to move to progressively greater restraint. If one assumed, for example, that the Committee still had in place its current 5 to 7-1/2 per cent growth range for M_1 and the associated ranges for the other aggregates, and then at a later time wanted to indicate that a more restrictive policy had been adopted, he would be inclined to act initially to reduce the lower limit to, say, 4-1/2 per cent, while leaving

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

the upper limit unchanged, and a little later to reduce the upper limit to, say, 7 per cent while leaving the lower limit at 4-1/2 per cent. Whether that procedure would be desirable was not something that had to be decided today, but the members might want to begin thinking about the question.

Mr. Francis observed that the use for the one-year period ending in June 1976 of the target growth ranges that had been adopted earlier for the one-year period ending in March 1976 would not represent a continuation of the previous policy because monetary growth in the second quarter of 1975 was faster than expected. From the point of view of controlling inflation, he was worried about the suggestion that the previous targets be retained since a repetition of the second-quarter pattern for a number of quarters in a row could cause the aggregates to deviate significantly from the Committee's original intentions.

Chairman Burns said he understood Mr. Francis' concern. He noted, however, that the present targets had been established only a short time ago, and he thought it would be confusing to change them at this early date. Moreover, since the Committee had wisely used rather wide ranges, the present targets provided ample elbow room. For example, if the 5 to 7-1/2 per cent range

was continued for M_1, those members who wished to move in a restrictive direction would favor growth rates near the 5 per cent lower limit and those who sought a more expansive policy would favor rates near the 7-1/2 per cent upper limit.

Mr. Francis said he would prefer to resolve the problem by retaining the March-to-March period for expressing the targets.

Mr. Holland said he preferred the wider latitude provided by shifting the time period forward by a quarter. He concurred in the arguments the Chairman had advanced for retaining the earlier numerical ranges, and he might note that even under A, the most expansive of the three alternatives presented in the blue book, the quarterly rate of growth in M_1 during the four quarters ending in mid-1976 would average about 7.1 per cent--within the 5 to 7-1/2 per cent range. At the same time, the Committee should be aware of the point Mr. Francis had made--that applying the same numerical targets to a forward-shifted time period did not necessarily mean that policy had not changed; it could amount to a move toward either an easier or a tighter monetary policy. At present, as Mr. Francis had implied, a decision to use the previously adopted March-to-March targets for the June-to-June period would, in effect, constitute agreement on a somewhat more expansive rate of monetary growth. In his judgment, that would

be appropriate, and the resultant rate of monetary growth would still be broadly consistent with the general course of policy that had been decided earlier.

Chairman Burns said he did not agree that the continuation of the previous ranges would amount to a move to a more expansive policy.

Mr. Mitchell remarked that while the Chairman had made valid points in favor of shifting the time period forward, he saw an advantage in retaining the March-to-March period. With the recovery under way, it might seem appropriate to begin thinking in terms of slowing the rate of growth in the money supply. Extending the current targets to cover the upcoming 12-month period would imply that the Committee had no such intention, whereas simply renewing them for the previous target period would not carry that implication.

Mr. Coldwell said he agreed with Mr. Mitchell's earlier comment that, having gone through the ordeal associated with reporting the Committee's longer-run policy intentions for the first time only 6 weeks ago, it was reasonable to maintain the same numerical targets for a while longer. Like the Chairman, however, he thought the time period should be extended to the 12 months ahead.

Mr. MacLaury remarked that the preceding discussion had strengthened his view that longer-term targets expressed in terms of broad ranges were so flexible as to have little meaning; they were a blanket that could cover quite different policies. During the initial discussion of one-year targets, he had argued for the use of narrow ranges to guard against just that possibility. Indeed, after further reflection he had come to favor a single-point target, although he realized that was a matter of tactics. In any event, he thought it was inconsistent to use single numbers for 6-month objectives and ranges for 12-month objectives, as in the current blue book, since greater precision could be expected in achieving the 12-month objectives.

Mr. MacLaury observed that alternative B involved a June-to-June range for M_1 of 5 to 7-1/2 per cent. As had already been noted, because of the overshoot in the second quarter, that alternative implied a higher growth rate for the March-to-March period than the Committee had agreed upon earlier; according to the blue book, the March-to-March growth rate implicit in B, using midpoints of the ranges, was about 7 per cent. In previous deliberations on the targets for the year ending in March 1976, he had advocated a 7 per cent M_1 growth rate, and he still thought such a rate would be appropriate. For that reason, he would

favor adopting the longer-run targets of alternative B at this meeting--at least if the midpoints of the ranges had any significance.

Mr. Morris said he seriously questioned whether a 5 to 7-1/2 per cent range for M_1 would provide adequate elbow room. He considered such a range to be tight on the high side; as the year progressed, the Committee might find it necessary to tighten short-term money rates prematurely in order to keep growth in M_1 below 7-1/2 per cent. Although he would not necessarily favor a growth rate above 7 per cent, he preferred a range of 6 to 8-1/2 per cent.

Mr. Debs said he agreed that the target range should cover the 12-month interval ending in June. He favored a 5 to 7-1/2 per cent range for M_1 during that period, but he would view that as a completely new target, justified by current circumstances. He did not expect any confusion to arise about the significance of that target in the course of the forthcoming Congressional hearing; he expected that at such hearings staff of the two Congressional committees involved would have charts and tables enabling the members to track the System's performance against its successive targets. That should be borne in mind.

The Chairman said it should be borne in mind also that the Committee's basic objective was to strengthen the national

economy, not to achieve any particular monetary growth rate agreed upon by the members at any given time. The Committee must not become a prisoner of its target ranges.

Mr. Black said he concurred in the advice given to the Chairman by Messrs. Rippey and Cardon on the matter of the time period to be used for target purposes, and he also agreed that the 5 to 7-1/2 per cent range for M_1 should be retained. If he were disposed to change that range, however, he would reduce the upper bound because he thought the recovery in economic activity had begun and past history indicated that the System tended to begin tightening too late in the cycle. Nevertheless, given the uncertainty about the timing and strength of the recovery, he would wait for more evidence that an upturn was under way before taking such action.

Mr. Eastburn remarked that he had spoken in favor of narrow ranges in the initial discussion of longer-term targets for a reason that he thought was now proving valid: the flexibility offered by wide ranges, which seemed desirable from some points of view, could raise questions regarding the credibility of the Federal Reserve as time passed. With ranges as wide as those being employed, the Congressional committees might well become distressed about the difficulty of determining what the

Federal Reserve actually intended to do. In a similar vein, if the 5 to 7-1/2 per cent range for M_1 was now applied to the year ending next June, the high growth rate of the second quarter would, in effect, be forgiven and might well lead to the question of whether the Committee had actually raised its target.

Chairman Burns commented that he would have no difficulty in responding that the Committee's basic policy had remained the same. The issue of credibility had not been raised in any of the large number of conversations he had had nor in any of the written material he had seen on the subject of the Committee's 12-month targets; as he had mentioned earlier, the announced targets had been generally well received. If the question was raised at some future time, as it might well be, the Committee would deal with it then.

Mr. Mitchell remarked that in some environments--for example, in a period of relatively stable monetary conditions--a narrow range for the monetary growth rate targets would be appropriate. At times, however, a wide range was necessary.

In reply to a question by Mr. MacLaury, Mr. Mitchell said he thought wide ranges would be needed at times when the relationships between monetary growth rates and other variables were particularly uncertain. Under such circumstances, efforts to achieve particular growth rates could have highly undesirable side effects.

Mr. MacLaury remarked that that problem might often arise in connection with short-run targets. He did not think it would be serious for longer-run targets, however, since there would be many opportunities to change the target numbers if developing circumstances indicated that they were not appropriate.

Mr. Mitchell observed that he did not have a great deal of faith in the value of the whole exercise of setting longer-run targets; the Concurrent Resolution was simply something the Committee had to live with. He agreed, of course, that monetary policy had to be flexible enough to deal with unfolding developments.

Mr. Kimbrel said he agreed with the Chairman's original recommendations and with the views Mr. Mitchell had just expressed. He also agreed with Mr. Baughman's earlier comments that businessmen were anticipating a renewed surge of inflation because they felt that fiscal policy would prove to be unduly stimulative. Accordingly, while he would favor applying the present longer-run target ranges to the 12-month period ahead, he would hope that operations would be aimed at achieving growth rates in the lower parts of those ranges.

Mr. Wallich remarked that he would have difficulty refuting the allegation that the targets had been raised if, despite the overshoot in the second quarter, the ranges that had been adopted for the March-to-March period were retained for the upcoming 12-month period. The Committee had the choice of accepting the overshoot or of attempting to get back on the original track. Because he preferred the latter course, he would favor reducing the lower limit of the June-to-June range for M_1 to 4-1/2 or 4-1/4 per cent. While that might appear to some to be excessive fine tuning, it would indicate that the Committee was aware of the recent overshoot and wanted to return M_1 to its previously adopted path.

The Chairman observed that that objective could be accomplished initially without changing the target ranges. As he had indicated earlier, he thought it would be confusing to change the ranges at so early a date.

Mr. Balles said he was fairly certain that most Congressmen expected the Federal Reserve to discuss its targets for the upcoming 12-month interval each time it reported to Congress under the provisions of the Concurrent Resolution. He might note also that in recent testimony on the GAO audit

bill Mr. Mitchell had made the important point that the Concurrent Resolution in effect provided for an audit of monetary policy to be carried out by the appropriate body--Congress. That argument would tend to be undercut if the Committee set targets for periods that extended only 9, 6, or 3 months into the future. With regard to the specific targets to be adopted, he shared the view that it would be premature to change the ranges at this time, although changes might well be in order before the following quarterly hearing.

The Chairman then observed that the Committee appeared to favor retaining for the period from June 1975 to June 1976 the ranges of growth rates for the monetary aggregates previously agreed upon for the March-to-March period. He asked whether there were any objections, and none was heard.

The meeting then recessed. It reconvened at 9:30 a.m. the following morning, with the same attendance as at the close of the Monday afternoon session.

Chairman Burns suggested that the Committee consider the memorandum from the Subcommittee on the Directive, dated June 12, 1975, and entitled "Role of Six-month Targets for Monetary Aggregates."[1/] He invited Mr. Holland to comment.

1/ A copy of this memorandum has been placed in the Committee's files.

Mr. Holland observed that the Subcommittee's memorandum had been prepared in response to a request at the previous meeting. To summarize the conclusions, the Subcommittee thought it would not be wise for the FOMC to adopt and publish targets for the monetary aggregates covering 6-month periods, as it did for the short-run specifications and for the 12-month targets, since that would involve an undue proliferation of targets and would suggest more precise marksmanship than the state of the art permitted. However, the Subcommittee believed that the 6-month projections of growth rates that were associated with each of the alternative sets of short-run specifications could be helpful to the members of the Committee, and to the Committee as a whole, in indicating the possible patterns of change in the aggregates. Accordingly, it believed that the incorporation of 6-month projections in the blue book, for whatever attention the members might wish to give them, would be entirely appropriate and, indeed, constructive. He might note that the current blue book conformed with the Subcommittee's recommendation.

Mr. MacLaury said he had a question on the methodology employed in developing the 6-month projections for the aggregates. Specifically, he wondered whether those projections were based on the assumption that the Federal funds rate would

remain stable at the level shown under the corresponding short-run specifications.

In reply, Mr. Axilrod said the staff's general procedure was to start with a 12-month horizon and attempt to develop a reasonable pattern of growth rates for 6-month--as well as shorter--intervals that would yield the indicated growth rate for the 12-month period as a whole. Often the growth rate for the 6-month period reflected an assumption that the funds rate over that period would remain within the range shown under the short-run specifications. Sometimes, however, a further change in the funds rate later in the period appeared necessary, and that would be indicated in the blue book. In the current blue book, for example, a 6 per cent funds rate was shown under alternative B. It was suggested in the discussion, however, that the funds rate would have to begin rising late in the year if the 6-month growth rates associated with B were to be achieved.

Mr. MacLaury remarked that he would find the 6-month projections to be particularly valuable in helping to trace the likely profile of short-term interest rates associated with each of the longer-run alternatives. Accordingly, the more explicitly the blue book set forth the implications for interest rates of the different growth patterns in the aggregates, the more helpful it would be to him.

Mr. Debs asked whether the Subcommittee would propose that the views of the Committee on 6-month targets be recorded, even though such targets were not included among the specifications.

Mr. Holland replied that, in general, that was not the recommendation of the Subcommittee. Of course, if the 6-month growth rates proved to be an important element of the Committee's decision at some particular meeting, it would be appropriate to record that fact.

Mr. Mitchell asked whether the projected growth rates for the monetary aggregates for the first and second halves of a 12-month period would customarily be expected to be different--because, for example, changing rates of growth were expected for nominal GNP.

Mr. Axilrod replied that differences in projected aggregate growth rates for successive parts of the 12-month period would undoubtedly be frequent; indeed, they occurred under all three alternatives in the current blue book, where each of the growth rates for M_1 for the second half of 1975 was about 2 percentage points above that for the first half of 1976. To again use alternative B as an example, the projections suggested that the 12-month growth rate centered on 6-1/4 per cent could be achieved with rates of 7-1/4 and 5-1/4 per cent, respectively, in the coming and the following 6 months. M_1 growth in the coming

6 months was expected to be faster than over the whole 12-month period because considerable expansion was already believed to be in train as a result of recent monetary policy and the relatively rapid expansion anticipated in nominal GNP for the first half of the 12-month period. A projection of M_1 growth at a stable 6-1/4 per cent rate in both halves of the 12-month period would have involved the assumption of a much sharper rise in interest rates in the near term than called for under B.

Mr. Holland noted that the 6-month projections could be thought of as a logical mid-passage between particular short-run specifications on the one hand, and a particular target growth rate for the 12-month period on the other hand, given current GNP projections. If with the passage of time actual monetary growth rates were found to deviate from the rates projected, the staff might present revised 6-month projections indicating how growth could be restored to the track representing the Committee's earlier preference for longer-run growth rates. The Committee would then be in a position to decide whether it wanted to retain or to modify its longer-run goals.

The Chairman said he thought the Committee was in general agreement with the conclusions of the Subcommittee on the Directive, as outlined earlier by Mr. Holland.

Chairman Burns then invited Mr. Wallich to comment on developments at the recent Paris meetings of the IMF Interim Committee and of the Fund and Bank Development Committee.

Mr. Wallich said discussions of the Interim Committee had focused on three main issues: gold, IMF quotas, and the exchange rate regime. It had appeared that the issue of quotas would be the easiest to resolve, and the Managing Director of the IMF had put forward a proposal. However, even that issue proved to be difficult. A number of countries had special objectives; the United States, for example, did not want to lose its veto power. Consequently, when the other two issues proved to be very difficult to resolve, no progress was made on quotas either. His impression was that the major countries felt no urgency to make progress on any of the three issues.

With respect to gold, Mr. Wallich continued, many countries seemed to think--or at least they said--that it was a matter of theology. He believed, however, that there was an important substantive difference between the French and U.S. positions: would the world monetary system gradually shift back to gold, as the French would like, or would it gradually phase gold out of the system, as had been agreed in the Committee of Twenty. The immediate task was to rewrite the IMF Articles of Agreement with respect to

gold. The U.S. objective was to incorporate an interim arrangement among major countries--essentially the Group of Ten--that would keep gold transactions among central banks to a minimum, that would assure that no new fixed price would be established, and that would be lasting. There was opposition on all points, and in the end the French declared that there was a fundamental disagreement.

Mr. Wallich observed that the discussions concerning the exchange rate regime were similar. He had thought that the French stand was merely a negotiating position. As it turned out, however, the French seemed seriously to believe that rates should be fixed once again and that floating should be a rare and limited expedient. The United States maintained that it had to have a clear option to float. Although the point had not been put this way, a return to fixed rates would require that the dollar be made convertible again and that U.S. monetary policy be subjected to the discipline of the balance of payments. Again, agreement could not be reached.

Mr. Wallich remarked that the Interim Committee would meet again just before the next meeting of the IMF in early September. He would guess that if any progress was made, it would be with respect to quotas.

The Development Committee, Mr. Wallich observed, had not been a very promising enterprise, but it did relatively well under the circumstances. The less developed countries called attention to their difficult situation, and the developed countries--while recognizing that something needed to be done--were trying to find a way to do the least possible at the lowest cost possible. In light of the Marshall Plan, the current attitude toward the LDC's was somewhat shameful, but the explanation could be found in the results of foreign aid and of the policies pursued by the LDC's.

Mr. Wallich said a third window would be established in the World Bank through which the LDC's would be able to obtain loans on terms somewhere between the completely concessionary ones of IDA and those of the market. The United States would not contribute to the new facility unless some solution to the gold problem could be worked out. There would be further discussion concerning a trust fund for LDC's, which originally had been a U.S. proposal. Finally, the IMF oil facility would provide for interest rate subsidies to the most seriously affected LDC's. Again, the U.S. position was that it could not contribute, even though the amount involved was minimal, but it wished the project well. Something undoubtedly would come of it.

Before this meeting there had been distributed to the members of the Committee a report from the 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 20 through June 11, 1975, and a supplemental report covering the period June 12 through 16, 1975. Copies of these reports have been placed in the files of the Committee.

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

> At the time of the last meeting, the dollar had once again come under selling pressure against major continental currencies. Market expectations of lower U.S. interest rates were an important factor, as were concerns over OPEC diversification into those currencies. As market pessimism resurfaced, the dollar was caught up also in the backwash of heavy outflows out of sterling, which required substantial dollar sales by the Bank of England. As part of those dollars were converted into continental currencies, dollar rates against those currencies were then depressed. The spectacular rise of the French franc also tended to pull other continental rates up against the dollar. As Mr. Pardee explained at the last meeting of the Committee, our operations--limited to German marks, Dutch guilders, and Belgian francs--were less effective than we wished.
>
> On May 22, however, after a further deterioration of the market atmosphere, the Bank of France agreed to a coordinated operation, with us offering francs in New York financed by drawings on the swap line on an equal profit-and-loss sharing basis. As Committee members may recall, since the current phase of our operations began in July

1973 the French have considered our insistence on equal sharing of risks on our drawings on other central banks and a full bearing of risks by them on their drawings on us to be asymetrical, if not unfair. But with other central banks--the Germans, Swiss, Dutch, and Belgians--willing to accept the principle of equal sharing with us, as a practical matter the French recognized that they must accept the same terms if they wish us to operate for our own account in francs in New York. At the time of the May Basle meeting, I had discussed the possibility of reactivating the swap line on an equal sharing basis or of our operating in New York for their account after the French market had closed. At that time it seemed that they preferred the latter course, but as often happens, circumstances altered the case.

With this added string to our bow, on May 22 we were able to operate in the market forcefully in French francs along with marks, guilders, and Belgian francs. Both the market and the news services responded favorably to this intervention, and with a very modest follow-up by us on subsequent days, the market soon found its own footing. The dollar then began to improve in response to yet another solid set of trade figures for the U.S. for April and to more optimistic signs of a bottoming out of the decline in the U.S. economy.

So far in June the dollar has been more firmly based but has not recovered its full April buoyancy. The recent decline in interest rates here is tending to dominate market thinking, and diversification of OPEC funds--either real or imagined--has occasionally depressed dollar rates. Moreover, sterling's volatility has been something of a disruptive force. The vote in the United Kingdom to remain in the Common Market led to only momentary euphoria, and traders focused once again on the serious problems facing the UK economy. As a result, sterling became extremely vulnerable to selling pressure of any kind. Last week a very large OPEC transaction--shifting out of pounds, through dollars, into marks--hit the market and, with only modest support by the Bank of England, sterling dropped off sharply. This

decline set off other speculative sales of sterling, which again tended to generate further sales of dollars for continental European currencies. In this uncertain atmosphere, we were prepared to operate forcefully in support of the dollar if necessary, but our actual intervention so far in June has been modest and has been only to avoid serious slippage when the dollar began to drop off in thin markets. The problem of the UK use of the swap line has not yet arisen, but it is one we shall have to pay close attention to in the months ahead.

Against major continental currencies, the dollar is now a net of 1/4 to 1-1/4 per cent below the levels at the time of the last meeting, but in much more settled trading conditions. Our intervention on six occasions since May 20 has amounted to $150 million. On the other hand, we have continued to use every opportunity to buy currencies in the market and from correspondents, including $50 million equivalent of German marks from the Bank of Norway, which represented the conversion by them of part of the proceeds of a Euro-currency loan. As a result, since the last meeting we have reduced our swap debt by $100 million, net, to $582 million.

Mr. Bucher observed that in the report on System foreign exchange operations for the week ended May 28, three developments were noted in connection with the downward pressure on the dollar that led to System intervention in the market on May 22--namely, market concern over the outlook for the United States economy, interest rate trends in this country, and further diversification of OPEC revenues. In his view those were longer-term developments, and he asked what the rationale was for System intervention in the foreign exchange market on that day.

In reply, Mr. Holmes said the purpose of System intervention had been to avoid abrupt changes in exchange rates. The prospect that recovery in economic activity would begin earlier and be stronger in this country than in some European countries had favorable implications for the dollar over the longer term. Those implications had been recognized in the market, but they were overcome by short-run influences. In the opinion of the Account Management, it would have been a mistake to have allowed the short-run developments--such as the decline in short-term interest rates in this country and the diversification of OPEC revenues--to depress the dollar and perhaps to initiate a process of deterioration of expectations for the dollar.

Mr. Pardee added that in any case the exchange market response to adverse developments was exaggerated. While the actual decline in the value of the dollar had been only 5/8 of one per cent before the System intervened, declines of 1 to 3 per cent a day seemed possible, and one would not expect declines of that size to occur over such a short time as the market adjusted to longer-term developments. The objective of the Desk was to avoid the kind of drop in dollar rates that had occurred last December and January. Before the Bank of France agreed to System intervention in francs in the New York market, the market had begun to respond to the sharp rise in the franc by bidding up other currencies.

Mr. Bucher remarked that he looked forward to gaining clarification of some of the issues involved in intervention from the Subcommittee that would review the foreign currency instruments.

Mr. Coldwell commented that he too looked forward to the results of the Subcommittee's efforts. If he understood correctly, the Desk was engaged in the difficult if not impossible task of trying to counter expectations.

Mr. Holmes observed that the Desk had been trying to prevent expectations from pushing rates too far in a short period of time, but that it had not attempted to prevent rates from moving at all. It was significant that over the past 3 months System purchases of foreign exchange in the market had exceeded sales. In addition, foreign exchange had been acquired directly from a few central banks, and the System's swap debt had been reduced substantially.

Mr. Wallich commented that some private foreign exchange traders with whom he had met in Frankfort conveyed an impression of having a very short-term view of developments. They might go in and out of the market as often as 40 times in a single day. With that kind of operation, short-term tendencies in the market could cumulate; if they lasted for only a few days, the traders could still make a great deal of money. In his view, intervention to halt such a cumulative development was appropriate.

Mr. MacLaury asked whether the dollar was likely to be subjected to additional downward pressure because of further weakness in sterling.

Mr. Holmes replied that the Bank of England almost certainly would continue to sell dollars in support of sterling. However, the position of the dollar would depend also on the demand for dollars coming both from the sellers of sterling and from other sources.

Chairman Burns remarked that OPEC countries, particularly those of the Middle East, were uncertain about United States policy regarding foreign investments in this country. More than one had somehow gotten the notion that this Government did not welcome investments from Mid-East countries.

Mr. Mitchell asked whether the System's exchange market transactions in foreign currencies were undertaken unilaterally or bilaterally with respect to the other foreign central bank concerned.

Mr. Pardee replied that the transactions were fully bilateral; the Desk always consulted with the foreign central bank, and there was full coordination. Even in the case of the System's purchases of German marks from the Bank of Norway, the German Federal Bank had been involved. Whether the System or the other central bank intervened in the market depended on

circumstances. Often the major pressure leading to intervention occurred in the European market. However, the Desk intervened in the New York market fairly often, because that market tended to be thin after the European closings around mid-day, New York time. If dollar rates started to drop off sharply in the afternoon, the Desk intervened in order to avoid having the lower levels established as the opening rates in the European markets on the next morning.

Mr. Mitchell remarked that the procedure evidently resulted in an implicit consensus between the two central banks that they wanted to resist the changes in rates that were tending to occur in the market.

Chairman Burns commented that the consensus was explicit rather than implicit.

> By unanimous vote, the System open market transactions in foreign currencies during the period May 20 through June 16, 1975, were approved, ratified, and confirmed.

Mr. Holmes then reported that three drawings on the German Federal Bank, totaling $26.8 million, would mature in the period from July 7 to July 10; two of the drawings, totaling $22.7 million, were second renewals and the remaining drawing was a first renewal. Last Friday the System had repaid two drawings that were coming due in early July. He hoped and

expected to repay the two older drawings prior to maturity, but he would recommend renewal of all three, if necessary.

> Renewal for further periods of 3 months of System drawings on the German Federal Bank, maturing in the period from July 7 to July 10, 1975, was noted without objection.

Mr. Holmes then reported that two swap drawings on the Belgian National Bank, totaling $31.8 million, would mature for the sixteenth time on July 17 and 24. Not much progress had been made in settling the Belgian franc problem. As Mr. Pardee had reported at the May meeting, negotiations were bogged down over the issue of loss-sharing. Mr. Wallich had worked out some alternative loss-sharing formulas which would be discussed with the Treasury tomorrow. The Treasury had offered, in effect, to take over completely the System's swap debt to the Belgian National Bank, but to continue it in the form of drawings on that Bank on a 3-month renewable basis rather than to convert it into long- or intermediate-term bonds denominated in Belgian francs.

While that approach deserved further consideration, Mr. Holmes continued, it had a number of drawbacks. First of all, a continuation of the swap debt with simply a change of debtors would not involve as clean a break as would repayment with the proceeds of a longer-term Treasury issue denominated in Belgian francs. Secondly, there was at least a suspicion on the part of some that this might be an entering wedge for the Treasury

to get the System out of swap transactions altogether. Thirdly, he seriously doubted that the Belgians would be very enthusiastic--to put it mildly--about taking on the Treasury as a partner in view of the latter's attitude about the true magnitude of the System's Belgian franc debt. Finally, there was a risk that differences between the Treasury and the Belgians would disturb some very good central bank relationships.

In response to questions, Mr. Holmes remarked that the Treasury's position was that the number of Belgian francs owed to the Belgians was uncertain and was a matter to be negotiated in the future, and he did not see how the Belgians could agree to the Treasury's proposal until that issue was settled. He thought the Treasury would have to yield on its loss-sharing demand or negotiate some compromise.

Mr. Wallich remarked that, in his view, the Belgians would be precluded from accepting substitution of the Treasury for the Federal Reserve as a debtor by their knowledge that the Treasury thought the United States owed them less than they thought was owed to them.

Mr. Holland observed that if he were an official of the National Bank of Belgium he would take precisely the position that Mr. Wallich had just indicated. Like Mr. Holmes, he believed it would be much better if the Treasury took the System out of

the short-term debt in an orderly fashion and issued longer-term securities, and he would want to encourage the Treasury to change its position. If the Treasury did take over the debt on a 3-month renewal basis, an attempt should be made to assure that it did so on a basis that would not jeopardize the System's foreign currency operations. Even though he believed that the Treasury's proposal was not in the best interests of the United States, however, it was better than no repayment at all, and it should not be rejected out of hand.

Mr. Holmes remarked that the Treasury's proposal could be considered further, but the Committee should be fully aware of its drawbacks.

Chairman Burns commented that the drawbacks were serious.

Mr. Holland said he agreed, but there were also serious drawbacks to the System's remaining in debt to the Belgians indefinitely. That would be flouting a principle the Committee had regarded as an important protection to the System's interests when it lent money on a short-term basis to other central banks. The System had emphasized that a guiding principle of use of the swap lines was that the debt could not remain outstanding indefinitely.

Chairman Burns observed that in his experience political considerations played a relatively small role in the thinking of central bankers and in their communications with one another.

Finance ministers, probably out of necessity, were much more influenced by such considerations. Consequently, Treasury involvement in Federal Reserve swap arrangements was not likely to be beneficial to the international monetary system.

Mr. MacLaury remarked that he agreed with the Chairman's view. In a different context entirely, the Treasury on occasion had made use of the Exchange Stabilization Fund to establish swap arrangements with other countries.

Mr. Wallich said one might view the outstanding debts in Belgian francs in a different framework. The United States did not hold foreign exchange reserves, unlike other countries, many of which held substantial amounts of dollars. In the way that the international system was evolving, countries defended their currencies by using their foreign exchange reserves to intervene in the market to some degree; they did not use gold or SDR's. The System's Belgian franc debt amounted to the beginning of a foreign exchange reserve position for the United States--although, unfortunately, with a negative sign. He recognized that the System had outstanding debt that was supposed to be short-term and that a debtor-creditor relationship existed. However, the monetary reserve aspect of the situation also needed to be considered.

Mr. Holland remarked that a similar point of view led him to suggest that the Desk be instructed to limit swap drawings

for intervention purposes to the amounts that the Committee believed it could repay out of its own resources--that until further notice the System should not, as it had in the past, count on a Treasury backstop in liquidating short-term debt on the swap lines.

Mr. Pardee commented that the Desk had been operating on that basis since market operations were resumed in 1972.

Chairman Burns asked whether the System had increased its debt to the Belgians in recent years.

In response, Mr. Holmes said the System had drawn on the swap line with the Belgian National Bank on a number of occasions in recent years to finance current operations in the exchange market. Drawings normally had been repaid within a matter of weeks. Currently, the System owed about $4 million as a result of a recent operation that had worked to the benefit of both parties. The recent drawings were kept entirely separate from the older ones that were the subject of the negotiations.

In response to further questions by the Chairman, Mr. Pardee observed that suspending operations in Belgian francs might achieve nothing beyond offending the Belgians further. It was their view that the System had the option of repaying the debt. One method, which was acceptable to the Belgians, was to buy small amounts of francs in the market on a

day-to-day basis, depending on market conditions. As a result, however, this country would bear the entire loss on the operations. In deference to the wishes of the Treasury, the System had not used that method.

Chairman Burns observed that the System had tried to work closely with the Treasury and by and large had been successful in doing so; it had not insisted on its prerogatives. When a principle was at issue, however, the Federal Reserve had to act as its own master.

Mr. Holmes said he would suggest that the conversations with the Treasury be carried forward, and in the event that no progress was made, that the System begin to accumulate small amounts of Belgian francs after having informed the Treasury of its intention to do so. The process of accumulating the necessary amount of francs would be slow, but at least it would have been started.

Chairman Burns commented that he thought the System should proceed in that way, although he might want to talk with the Secretary of the Treasury before doing so. He assumed that Mr. Holland would not be unhappy that the process was a slow one, as long as some progress was being made.

Mr. Holland remarked that he would be satisfied.

Mr. Wallich said the negotiations with the Treasury were continuing. His simple argument that the United States owed a certain amount of Belgian francs and had to pay that amount had not convinced Treasury representatives. The legal position seemed to be that with some effort one could interpret the contract in the way that the Treasury wished to, but one could more easily interpret it in the way the Belgians did. His hope was that a loss-sharing formula other than 50-50--perhaps, 2/3-1/3 or 3/4-1/4--would be acceptable to the Belgians. It was important to continue the effort to reach a settlement, because the results had a bearing on outstanding drawings on the Swiss National Bank. The Swiss were willing to accept some degree of loss-sharing.

Chairman Burns said he thought all Committee members would favor continuation of the negotiations. He believed that a solution could be found. However, the negotiations should not be continued indefinitely. If a settlement was not reached in about 60 days, the System had the responsibility and the authority to resolve the problem.

Mr. Holland remarked that he certainly could agree that negotiations with the Treasury should continue that much longer.

By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, maturing on July 17 and 24, 1975, was authorized.

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 20 through June 11, 1975, and a supplemental report covering the period June 12 through 16, 1975. 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:

> Desk operations since the last meeting started out with a view to keeping money market conditions about unchanged from the objective just before that meeting--with the Federal funds rate in a 5 to 5-1/4 per cent range. Quite soon after the May meeting, however, the monetary aggregates began looking considerably stronger and the Desk responded by encouraging money market conditions toward the upper part of that 5 to 5-1/4 per cent range. Most recently, with both M_1 and M_2 expected to exceed their specified May-June ranges, the Desk has aimed at a funds rate somewhat above 5-1/4 per cent.
>
> Efforts to achieve somewhat greater firmness in the latter part of the period were frustrated to some extent by bank willingness to let reserve deficiencies accumulate; consequently, the funds rate averaged only 5.15 per cent in the week of June 11 despite large-scale and persistent System action to extract reserves. Most recently, further and somewhat more aggressive actions to absorb reserves have produced greater firmness--with an effective funds rate yesterday of 5.34 per cent.
>
> As in other recent months, the roller-coaster Treasury balance has been a major force shaping System actions. Reserves were absorbed through a variety of means as Treasury balances worked down from over $7 billion at the start of the period to around $1 billion in recent days. Most of the absorption was accomplished through the maturing of repurchase

agreements and the arrangement of matched sale-purchase transactions. In addition, outright System holdings were cut by around $900 million through redemptions of maturing issues and about $500 million through sales of bills to foreign accounts.

By and large, market participants have understood fairly well the reasons for large-scale System operations to offset technical factors like the Treasury balance, but at times the sheer magnitude and persistence of Desk operations in one direction or the other has tended to foster some misunderstandings and to complicate the realization of Committee objectives. On two occasions in the recent period the Desk considered it desirable to call the market's attention to the large reserve job at hand in order to avoid serious misinterpretation of large-scale efforts to put in or take out reserves. We would expect to use such messages only on rare occasions and for the most part to let our actions speak for themselves.

The credit markets strengthened during the past several weeks. Early in the period there was a widespread view that System policy was tending easier, with the Federal funds rate likely to dip below 5 per cent. While this view was dispelled, considerable buoyancy remained as market observers were impressed by the progress in dampening inflation, the likelihood of a slow business upturn, and prospects for less onerous Treasury cash needs in the next month or two than had been anticipated earlier. The municipal market remained under a cloud until late in the period, partly because of New York City's fiscal problems, but the creation of a Municipal Assistance Corporation to fund part of New York's short-term debt brought considerable relief to that sector in recent days. New York City still faces a serious budget problem, however, and the borrowing problem could also return in a few months when the respite now provided by "Big Mac" runs out.

A steady stream of bank and other investment demand has contributed to the improved credit market tone. Dealer inventories of Treasury issues due in over one year have come down from about $2 billion at the time of the last meeting to around $700 million

by last Friday. Against this background, vigorous bidding is expected in today's auction of $2 billion in 2-year notes, to refund a similar amount of bills maturing June 30.

Unlike coupon issues, dealer inventories of bills have grown over the past month, but rates have also come down in that area in recent days as the market looked forward to temporary paydowns of bill borrowings by the Treasury. This prospect was a prominent factor in yesterday's weekly auction, where a large paydown limited the amount of bills available to the private sector. Average issuing rates of 4.77 and 5.13 per cent for the 3- and 6-month issues compared to 5.12 and 5.41 per cent 4 weeks earlier and somewhat higher rates in most of the intervening auctions. Even with unchanged money market conditions, bill rates seem likely to push higher in the weeks ahead, particularly when the Treasury returns to the market to meet its deficits.

In more general comment on the rate outlook, it might be noted that current market expectations seem to be geared to a Federal funds rate in the 5 to 5-1/2 per cent area. Anticipations of a dip below 5 per cent have been dispelled, but an upward move from recent levels is not generally expected and could have some broad market impact. However, with dealer inventories light, and not much Treasury financing on the immediate horizon--apart from the 2-year note today--the market should be able to cope satisfactorily with moderate-sized System moves on reserve availability.

In response to a question from the Chairman, Mr. Sternlight said the Desk had made few purchases of coupon issues recently because it had been engaged primarily in reserve-absorbing operations as the Treasury had sharply drawn down its balances at the Reserve Banks.

Chairman Burns observed that leeway for purchases of some coupon issues could have been provided by making additional sales of Treasury bills. In light of Congressional interest in

the attainment of lower long-term interest rates, questions might well be raised about the limited volume of System activity in coupon issues over the past 6 weeks.

Mr. Sternlight remarked that the Desk had tended to confine purchases of coupon issues primarily to occasions when there was a need to supply reserves. Operations involving sales of bills and purchases of coupon issues might have been carried out if severe rate pressure had emerged in the coupon area, but such pressure had not existed in recent weeks. He might note, however, that System holdings of coupon issues had increased substantially since the beginning of 1975.

Mr. Holmes observed that long-term interest rates had declined considerably over the past 6 weeks as a result of the working of market forces; in effect, progress had been made toward the objective of lower long-term interest rates through the natural functioning of the market. He thought it was advantageous for the System to refrain from intervening in the long-term market when it was working well on its own.

Chairman Burns remarked that that was a reasonable position.

Mr. Bucher referred to Mr. Sternlight's comment that the market did not expect the Federal funds rate to move up from the present 5 to 5-1/2 per cent area. He asked about the likely market reaction if the funds rate were to rise to about 6 per cent, the midpoint of alternative B.

Mr. Sternlight replied that, because dealer inventories were light, the market probably could absorb an increase in the funds rate to a level somewhat above 5-1/2 per cent without an unduly sharp rate reaction. A rapid increase to 6 per cent, however, would be likely to produce a fairly sizable reaction.

Mr. Axilrod observed that under such circumstances, it might be appropriate for the System to purchase coupon issues in an effort to moderate interest rate adjustments.

Mr. Black asked Messrs. Sternlight and Holmes for their views on the interest rate projections that had been presented by the Board's staff yesterday.

Mr. Sternlight said he had no particular quarrel with the projections of interest rates, although he thought that progress on the inflation front might result in less upward pressure on long-term interest rates than the staff anticipated.

Mr. Holmes remarked that his ability to forecast interest rates for extended periods ahead was quite limited. It was his intuitive feeling, however, that the projection of short-term interest rates in the 10 per cent area was on the high side.

Mr. Coldwell asked if the Desk was proceeding on the assumption that the Committee wanted it to purchase longer-term Government securities whenever possible.

Mr. Sternlight observed that a need for reserves would develop after the mid-June tax date, as the Treasury rebuilt its balances. He expected that the Desk would meet part of that need by purchases of coupon issues.

Mr. Holmes added that, in general, the Desk preferred to operate in the coupon market in accordance with specific instructions from the Committee rather than on the basis of its own interpretation of the Committee's desires.

Chairman Burns remarked that his impression, based on discussions at previous meetings, was that the Committee had encouraged the Desk to be more active in the coupon market--partly because of its interest in doing what little it could to curb increases in long-term interest rates and partly because of the explicit language regarding such rates in the Concurrent Resolution. He asked whether that statement accurately reflected the Committee's thinking.

Mr. Mitchell said he thought it did. However, the more significant question, to his mind, was whether the Committee wanted the Desk to engage in an "operation twist," selling bills and buying longer-term securities. He personally would like to see some efforts in that direction, particularly if the System intended to encourage an upward movement in short-term interest rates. In any event, it was a matter he thought the Committee should consider.

Messrs. Coldwell and Holland indicated that they were not willing to explicitly endorse an operation of that type at this time.

Mr. Eastburn suggested that it would be unwise to rule out such an operation since it might prove to be necessary, and Chairman Burns agreed.

There was general agreement with the Chairman's suggestion that the practical wisdom of being more active in the coupon market should be borne in mind.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 20 through July 16, 1975, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement on prospective financial relationships:

> Two of the three alternatives[1] presented for Committee consideration involve a tightening over the near-term in bank reserve and money market conditions. This tightening is predicated mainly on the staff's forecast of more than a 12 per cent annual rate of increase in nominal GNP during the summer months--a rate of growth that would be expected to entail a strong expansion in transactions demands for cash.
>
> In view of this, it would seem that the odds on attainment of the FOMC longer-run monetary growth targets--as indexed by a 5 to 7-1/2 per cent growth range for M_1--would be enhanced by some move toward tightening over the weeks ahead. While maintenance of prevailing money market conditions would not necessarily be inconsistent with longer-run monetary

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

growth of that magnitude, the staff believes that such a posture would require a more substantial tightening of money market conditions later and therefore would be more consistent with adoption of higher longer-run monetary growth targets.

Both alternatives B and C encompass tighter money market conditions, with alternative C involving the most restraint. The reason for the greater market tightness in alternative C is that it looks toward slower monetary growth rates than alternative B. The tighter market conditions can also be construed, however, as part of an effort to compensate for the overshoot in monetary expansion that appears to have developed during recent weeks.

Whether it is necessary to make some special effort now to compensate in some way for the second-quarter overshoot in monetary growth is, of course, a matter on which there are pros and cons. On the basis of current estimates, M_1 growth in the second quarter is expected to be at about a 9 per cent annual rate, but this follows a 2.4 per cent rate of growth in the first quarter, so that for the first half of the year growth is likely to be on the order of 5-3/4 per cent, annual rate. Moreover, the very rapid expansion of the monetary aggregates in May and June--caused to an important extent by one-time Treasury payments of tax rebates and social security bonuses--could unwind on its own by more than we have projected. On the other hand, recent monetary growth has been more rapid than we anticipated, even after allowing for such special factors, and we cannot be certain that more fundamental factors influencing the demand for money, such as a strengthening economy, may not already be at work.

As the documents before the Committee indicate, short-term credit markets are not yet reflecting any strengthening of credit demands that might be associated with substantial economic recovery. That has contributed to the Federal funds rate remaining low relative to Desk intentions, as banks' money managers have been reluctant to bid up for Federal funds in a period when other means of adjusting reserve positions--such as selling bills--have become less expensive. Given the expected rebound in Treasury borrowing demands after midyear, perhaps slightly less weak

> private demands, and also reserve drains on member banks as the Treasury balance at the Federal Reserve is rebuilt, it should not prove as difficult over the period ahead to exert upward pressure on the funds rate if the FOMC were to opt for such an approach.
>
> In assessing its approach to the money market today, the FOMC may also wish to consider the implications of adjustments to the short-run ranges of tolerance for the monetary aggregates. For example, the bottoms of the ranges could be lowered by a point or so to indicate the acceptability of relatively modest monetary growth rates in the wake of the rapid May-June expansion in money. Such an approach might be most useful operationally if the FOMC adopted a funds rate range centered near prevailing conditions but did not wish to permit any money market easing if monetary growth rates were relatively low.

Mr. Holland asked if Mr. Axilrod's comments subsumed the monetary aggregate targets for June 1975 to June 1976 that had been agreed upon yesterday.

Mr. Axilrod replied that they did. Although alternative C in the blue book was related to a lower longer-run target path, the short-run money market specifications of that alternative could also be viewed as a way of compensating more quickly for the rapid rate of monetary growth in May and June, while still aiming for the longer-run growth rates agreed upon yesterday.

Chairman Burns then said he wanted to raise some issues that the members might wish to consider in the discussion of monetary policy. The Committee had already decided upon its

12-month targets for the monetary aggregates, but as he had intimated yesterday, he thought it was important for the Committee to begin thinking about even longer-range goals for the aggregates. He was not suggesting a formal vote or decision at this time. However, if inflation was ever to be brought under control--and he did not think the nation would solve the problem of unemployment unless it was, if even then--a more subdued rate of growth in the monetary aggregates would be required. For M_1 the Committee might have to think in terms of a growth rate in the area of 2 or 3 per cent, rather than 6 or 6-1/2 per cent, and to work gradually toward such a lower rate. In light of various developments that were making M_1 increasingly obsolete, its rate of growth might have to be even lower.

Secondly, the Chairman observed, he believed the Committee should be devoting more attention to the broader measures of money. The growth rates in M_1 during the past 6 months and the past 12 months had been quite moderate--between 4 and 5 per cent. However, when one considered the expansion of M_3 or M_5 over the same periods, it was clear that liquidity had been created at a very rapid pace.

Another question, the Chairman continued, was that of velocity. He found it gratifying that the Committee was devoting

more attention to velocity than it had in the past, but he wondered whether the Committee should not be giving the subject even more attention. That was one of the few areas where he saw the world rather differently from Mr. Wallich. He (Chairman Burns) believed that the primary determinant of velocity was the state of confidence; the rate of interest was correlated with the state of confidence, but econometricians had not found effective ways of disentangling the influence of one from the other. If his thinking was at all cogent on this point--and perhaps even if it was not--he thought the Committee should consider the broad question of how it might help to improve confidence. In his judgment confidence was gradually being restored across the nation, and he believed that the moderate policy course the Federal Reserve had been pursuing over the past year had been contributing to that improvement. As one indication he might note that, while the voluminous mail he received tended to be favorable on balance, in recent weeks the proportion of favorable letters had been higher than at any time in the past that he could recall.

Another difficult question before the Committee today, Chairman Burns observed, was whether it should tolerate a moderate rise in short-term interest rates. That question was becoming inescapable. If the answer was in the affirmative, he thought

the Committee needed to examine more fully an issue it had already discussed today--its policy regarding the purchase of coupon issues. Finally, he thought some of the comments he had made yesterday on structural policies, and those Mr. Wallich had made today on incomes policy, deserved some attention from the Committee. There were limits to what monetary policy could accomplish and a danger that the Committee might try to attain objectives that could not be achieved or that could be achieved only at great cost to the nation over the longer run, if not in the immediate future.

Those were some of the basic questions in his own mind, Chairman Burns said. The members of the Committee might wish to comment on some of them, as well as on others that they deemed important, in the discussion of monetary policy. He would suggest that the Committee again follow the procedure used at the preceding meeting, under which the members focused initially on the broad direction of policy, reserving comments on numerical specifications for a later point.

Mr. Balles said that insofar as the general thrust of monetary policy was concerned he had been rather pleased by recent developments. He was among those who had favored front-end loading in implementing the Committee's objectives for the aggregates over the next year. Some front-end loading had been

achieved in recent weeks, possibly due to transitory developments associated with tax rebates and other Treasury payments. He agreed with the Chairman's assessment of the vital role of confidence in the economy, and he thought that it might now be improving gradually. Confidence remained fragile, however, and for the short run--until it improved somewhat further--he felt it would be desirable to permit the monetary aggregates to expand at rates somewhat faster than those agreed upon by the Committee for the next year. He would be concerned if short-term interest rates rose very much in the immediate future.

Mr. Bucher observed that in his opinion the time to tighten money market conditions had not yet come. As Mr. Axilrod had noted, the annual rate of growth in M_1 over the first half of the year would be on the order of 5-3/4 per cent, if the staff's current estimate of second-quarter growth proved to be correct. In view of the economic situation and outlook, that was not an excessive rate of growth--especially after allowance for the transitory influence of the income tax rebates and the payments to recipients of social security benefits. As yet there were no clear indications of the forces that would lead the economy out of recession, and so it would be premature to bring about increases in interest rates. Such increases could severely damage recovery.

Mr. Bucher added that in his opinion major emphasis should be given to promoting recovery in economic activity. Staff projections suggested that in the fourth quarter of 1976 the rate of capacity utilization would be 76 per cent for major materials and 71 per cent for all manufacturing, and the unemployment rate would still be as high as 8.5 per cent. Given that prospect for resource utilization, he saw no threat of intensified inflationary pressures for some time to come.

Mr. Coldwell remarked that he could agree with much that Mr. Bucher had said. He was not unhappy about the high rates of monetary growth, perhaps because he attributed a significant part of the expansion to the tax rebates and to the prospective payments to social security beneficiaries. While he would not want monetary growth to persist at rapid rates throughout the summer, neither did he want to see interest rates begin to move up. The Committee could wait another month and observe developments. He believed that tightening of money market conditions would become necessary some time during the summer, but it would be premature now. For the present, he would maintain the funds rate in the range of 5-1/4 to 5-1/2 per cent.

Mr. Mayo said that many of the points he had planned to make had already been made by others. He agreed with those who felt that the Committee should not foster higher interest rates

at this point despite the fact that the May-June target for M_1 was being exceeded. That outcome, he thought, was due partly to an aberration relating to the greater concentration of tax rebates and social security payments than was contemplated at the time of the previous meeting. In his judgment, the economic outlook was still sufficiently uncertain to recommend a policy that would promote stable interest rates. Perhaps his views were colored by the lagging nature of the Chicago-area economy, but he thought an overt move toward higher interest rates would be regretted within a few months. Indeed, he would prefer to see a somewhat lower prime rate, and he would avoid Federal Reserve actions that might cause bill rates to rise from their current levels. As to the aggregates, he thought some front-end loading could be accommodated within the Committee's 12-month targets. According to staff projections, the rate of growth in M_1 was likely to moderate in July and if one looked back over the first half as a whole its growth rate was found to be relatively modest.

Turning to the other questions that had been raised by Chairman Burns, Mr. Mayo said he thought it was appropriate for the Committee to give more attention to its long-term goals for the aggregates. Such goals needed to be related to expectations for the economy extending well beyond the period covered by the staff's projections. He found himself unprepared, however, to

discuss specific targets for the aggregates over so extended a period without first giving considerably more study to the concept of longer-range goals and also to the selection of broader measures of money, assuming that evolution of the payments mechanism tended to make M_1 somewhat obsolete. He had even less confidence in his ability to deal with the problem of velocity. He agreed that it was important for the Committee members to keep a close watch on velocity, because its behavior obviously had implications for the multiplier effect of a given expansion in the money stock.

Mr. Debs said he was somewhat concerned about the recent expansion in the monetary aggregates. He recognized that a good argument could be made in favor of more rapid growth in the aggregates than was contemplated by the Committee's 12-month targets, since a relatively slow economic recovery was projected with the rate of unemployment continuing high and excess capacity remaining substantial. However, he believed it would be shortsighted for the Committee to focus all its attention on maximizing the economy's recovery over the next year. It would be desirable to begin thinking about a strategy that concentrated on the longer term and that worked toward a gradual reduction in the growth of the aggregates to a rate compatible with long-run price stability. The staff's alternative projection

involving a more stimulative economic policy package, including a 7-1/2 per cent rate of growth in M_1, produced results for unemployment and prices over the next 18 months that would be relatively attractive if realized. However, he had reservations about the price projections under that alternative. As Chairman Burns had suggested, confidence was a crucial factor that had to be taken into account. Accordingly, he was more concerned about bringing the long-run rate of inflation under control than he was about achieving maximum recovery in the coming year.

Referring to the questions raised by Chairman Burns, Mr. Debs said he would agree with Mr. Mayo that more attention should be paid to velocity. He also thought that as time went on the Committee should lower its long-run targets for M_1 growth to 3 or 4 per cent or whatever rate might prove suitable, taking into consideration the role of M_1 in relation to that of the broader aggregates. He believed that the need for structural changes in the economy had to be brought into focus somehow, and that the Committee should contribute as best it could to that end. However, like Mr. Mitchell, he was not sure how that might be done. That was a matter for further discussion.

Chairman Burns said he could recall instances in the past when System officials had made recommendations relating to structural problems, and also to incomes policies. In addition,

directors of Federal Reserve Banks had communicated their views on such matters to Administration officials and to members of Congress. Members of the Committee might now want to speak out on those matters as individuals. Some issues had delicate aspects and prudence would have to be exercised. Nonetheless, System officials had a duty to comment on large public issues. As he had suggested earlier, there was a risk that the burden placed on monetary policy might be heavier than it was able to support. Mistakes had been made in monetary policy over the years; for example, the inflation that began in the mid 1960's would not have occurred if monetary policy had not contributed to it.

Mr. Morris noted that at a meeting of the Subcommittee on the Directive held yesterday, a staff member had described his view of the Committee's operational procedures in the following terms: the Committee first decided on the appropriate rate of expansion in the economy and then it exercised its best judgment as to the rate of growth in money and the level of interest rates that would be most conducive to producing the desired economic expansion. However, he (Mr. Morris) thought the Committee had not proceeded in that fashion when it had decided on the 12-month goals for the aggregates that were communicated to Congress in early May. The staff had indicated that on the basis of its

best judgment the monetary growth targets agreed upon would be compatible with a rate of expansion in the real economy over the next year of about 5-1/2 per cent, but the Committee had never really debated the issue of whether such a rate of economic growth would be optimal in light of the desperate need to cool off inflation.

As the members would recall, Mr. Morris continued, he had argued yesterday that the Committee's long-run goals were on the low side. He held that view because he thought the optimum rate of growth in the economy over the coming year was in the neighborhood of 7 to 8 per cent. He did not agree with those economists who urged seeking an economic growth rate of 9 or 10 per cent, partly because he doubted that monetary policy could produce such a high rate of expansion, and partly because if such an acceleration could be achieved it would be extremely difficult to slow the expansion down to a sustainable pace later. On the other hand, he was very much concerned that any rate of economic growth below 7 per cent would entail a substantial cost in terms of employment with little, or no, benefit on the price side. In sum, he thought a 7 or 8 per cent rate of growth in economic activity over the next year would be compatible with the objective of resisting inflation and he continued to be concerned that the Committee's current policy would not achieve that optimum growth rate.

Mr. Morris added that the structural problems mentioned by Chairman Burns were serious. While he felt that such problems would become more important as the economy approached full employment, he agreed that they should be discussed now since a public debate extending over a number of years would probably be required before Congress could be expected to take effective action.

Mr. Wallich said he was encouraged by what had seemed to be a consensus around the table yesterday with regard to the desirability of fostering a further decline in the rate of inflation rather than moving into a new cyclical expansion with the expectation that at least temporarily the rate of inflation would pick up again. The latter approach would mean that the chance to bring inflation under real control would come only at the end of the next cyclical expansion. He was not sure his interpretation of the Committee's consensus was accurate, but a basic policy decision was involved. To foster a further decline in inflation now would be somewhat costly in terms of unemployment in the short run, but he thought such a policy would prove beneficial to employment over the long run. He had come to the conclusion that inflation and unemployment were positively correlated; as the economy experienced progressively higher rates of inflation, unemployment also moved, with a lag, to progressively higher levels--even though in the short run an acceleration of the

economy might temporarily serve to bring unemployment down until inflation caught up once again.

Therefore, Mr. Wallich observed, he favored a moderate recovery path. He would be concerned if economic activity were to expand at a rate of 8 per cent. He thought a rate of 6 or 7 per cent could be managed, provided it was recognized that growth would have to be moderated while the economy was still a considerable distance away from full employment--which might involve an unemployment rate in the neighborhood of 5-1/2 per cent--in order to prevent a resurgence of inflation.

If the growth objectives he had in mind were to be achieved, Mr. Wallich continued, the monetary aggregates could not be permitted in the short run to exceed the Committee's longer-run targets by too large a margin. While the rapid expansion in the aggregates in the second quarter apparently reflected special factors, it was important to recognize how that short-run development had interacted with the setting of the Committee's long-run targets; even though the aggregates had been pushed off track, the Committee had found good reasons for not moving aggressively to bring them back. Because such patterns could recur repeatedly, there was a tendency for the Committee to lose control of the aggregates on either the upside or the downside. That tendency was strengthened by the Committee's

reluctance to change the Federal funds rate very much; there always seemed to be good reasons for not permitting that rate to move very far from whatever its current level happened to be.

Right now, Mr. Wallich observed, there was a danger that the aggregates would get out of control on the upside unless the Committee was more flexible with respect to the funds rate. While he was not prepared to accept without qualification the advice one always got from monetarists in such a situation, there did seem to be some elbow room for letting the funds rate move higher. In particular, the funds rate had been surprisingly low; the bond market had been quite strong; and thrift institutions were very liquid. He favored taking advantage of the present opportunity to exert more restraint on the growth of the aggregates.

Mr. Francis indicated that Mr. Wallich had anticipated his own remarks, and in the interest of saving time, he would simply endorse Mr. Wallich's statement.

Mr. MacLaury said he had a feeling that the economic situation and outlook were stronger than suggested by the Board's staff--and also by the staff at his Bank. His more optimistic view was based mainly on his impression that consumer confidence, and therefore the outlook for consumer expenditures, were stronger than the staff believed. It was his guess that growth in economic activity would exceed a rate of 6 per cent over the

next six quarters. In line with that impression, he believed the current performance of the monetary aggregates reflected not only the impact of tax rebates, but also some developing strength in the economy. He could, of course, be wrong in that view, and he realized that an enticing case could be made on economic grounds in favor of front-end loading in working toward the Committee's longer-run targets for the aggregates. In his judgment, however, the political risks of having to let interest rates rise more rapidly later to curb expansion in the aggregates outweighed the economic arguments for front-end loading.

Efforts at this juncture to moderate the expansion of the aggregates could prove to be premature, Mr. MacLaury observed. However, he saw a greater danger that over the year ahead the Committee would not be prepared to let short-term rates move up along the path outlined in the staff presentation or by enough to hold the growth of money to the Committee's longer-run targets. In that connection, he thought it was significant that some members of the Committee this morning were defining "tightening" in terms of interest rates. While there were different theoretical bases for evaluating monetary policy, he was concerned about the possibility that during the economic upswing the Committee would shift its focus from a definition of policy that emphasized the aggregates to one framed strictly in terms

of money market rates. Accordingly, he came to a paradoxical conclusion: the rates of growth in the monetary aggregates that he favored for the year ahead were higher than those preferred by a majority of the Committee members, but he was nonetheless prepared to see short-term rates begin to move up even now, when there was still only a hint of emerging strength in the economy.

Turning to the questions raised earlier by the Chairman, Mr. MacLaury said that in considering long-term goals for M_1 and the broader measures of money, the Committee should continuously keep in view the structural and technological changes that were taking place in the financial system. It was important to concentrate on assessing the degree of stability in the relationships between money in its various definitions and GNP. Those relationships might well be changing, but he had not yet seen any evidence that the relationship to GNP of M_3 or M_5 was more stable than that of M_1 or M_2. In fact, he believed the opposite was true. He was not sure how measures of velocity might best be used, but he thought relationships involving velocity offered an alternative analytical approach to the same issues, and the question of the choice of the best approach should again be resolved on the basis of the relative stability of the relationships involved. In the area of structural problems, Chairman Burns had suggested in Congressional testimony several months ago that

a program of public service employment might be desirable when unemployment reached certain levels. He (Mr. MacLaury) was intrigued by the concept of a zero unemployment target made possible by the provision of full employment by the Government. Members of the Committee were well aware of the difficulty of trying to justify a particular monetary policy when it was associated with relatively high unemployment. The dilemma would not be resolved until, in effect, a different definition of unemployment was made possible.

Mr. Kimbrel said he too believed that a moderate economic recovery was under way, evidenced in part by what he perceived to be a considerable improvement in consumer confidence. He was less optimistic, however, about the long-run prospects for inflation. Prices of some basic materials were already rising, and he questioned the nation's ability to restrain increases in wages in an inflationary climate. He was equally concerned about the prospects for an overly stimulative fiscal policy in light of the continuing high rate of unemployment and the approach of an election year. His monetary policy preference would be to hold to the 12-month targets for the aggregates that the Committee had adopted. As had already been suggested, a slight increase in interest rates could be tolerated under current circumstances, and in view of the probable difficulty of having to move them up rapidly later in

order to curb monetary expansion, he would accept some gradual increase at this time.

Mr. Mitchell remarked that, while his own record on predicting turning points was not good, he would note that he could not see any clear evidence so far of an upturn in economic activity. There was no doubt that liquidity had improved markedly in the economy, but he was not sure whether it had improved enough to support a recovery. He thought banks probably were still working to increase their liquidity; corporations certainly were. Individuals had paid off a great deal of debt and they had been accumulating a large stock of claims on depository institutions. However, the psychology of investors and financial institutions had not been such as to bring down the level of long-term interest rates, and he was worried about that level. Accordingly, when Committee members spoke of a move to tighten money market conditions, he found himself worrying about the impact of such a policy on long-term debt markets. On the other hand, there obviously had been a substantial injection of money, not all of which was evidenced by the performance of M_1, and he continued to be concerned about the role of the Euro-currency market in financing inflation not only in the United States but in the rest of the world. Thus, he could be alarmed very easily by developments relating to both interest rates and the monetary aggregates.

In weighing those considerations, Mr. Mitchell observed, his policy preference came out close to that of Mr. Coldwell. He was not anxious to see much change in the Federal funds rate. He saw no reason for that rate to dip much below current levels, nor would he favor a rise toward 6-1/2 per cent, the upper limit of the range associated with alternative B. In sum, he would permit the Federal funds rate to remain stable or to edge a little higher.

Mr. Eastburn said he thought the Chairman's suggestion that Committee members pay more attention to velocity was quite appropriate, and he noted that the staff had taken velocity into consideration in making its projections. As he had indicated yesterday, he and his associates at the Philadelphia Bank were assuming an increase in velocity about equal to the average for periods of recovery. Their analysis led them to the view that even if the increase were above average, the rate of unemployment would not be much affected. His conclusion was that no special adjustment should be made in the target for money because of velocity considerations, although he would not rule out an adjustment if velocity were changing in an unanticipated way.

With respect to the Committee's current short-run policy, Mr. Eastburn said, the issue seemed to him to be largely one of timing. He was beginning to get uncomfortable with the recent

rates of monetary expansion, but he agreed with those who felt that now was not the time to pull back on monetary growth by inducing a higher Federal funds rate. One reason was that he was in favor of front-end loading. Another was that he preferred to see how lasting were the effects of current Treasury transactions on the money supply; he hoped more moderate rates of growth would materialize shortly. There was some risk in that approach--namely, that monetary growth would be faster than the Committee desired. In that event, the Committee would have lost a month and it might have to induce sharper rate increases later in order to control the aggregates. At the moment he was willing to take that risk. To hedge a bit, he would accept Mr. Axilrod's suggestion of reducing the lower limit of the short-run ranges of tolerance for the monetary aggregates.

Mr. Winn said he wanted to echo Mr. MacLaury's concern about the problems created for policy by high rates of unemployment. Yesterday, he had found sobering the staff projection that current economic policy would be associated with a continuing high rate of unemployment next year. In light of the political environment that would then be prevailing, the Federal Reserve had to be as innovative as possible in making suggestions for reducing unemployment, in order not to sacrifice its anti-inflationary objectives. Those suggestions might include, for example, a program of public

investment in education to help relieve the high concentration of teenage unemployment. He hoped the System would be able to avoid abandoning its efforts to combat inflationary pressures, which were being compounded by all sorts of structural problems and also by cost pressures relating to the environmental factor.

Mr. Winn went on to say that economic activity in the Cleveland District, as in the Chicago area, was lagging behind the nation. The steel industry, which was an important factor in the District, was still reducing operations, and that was casting a pall on area business conditions. Yet, he sensed that the nation's economy was in a turning phase, although he suspected the recovery might not be as strong as Mr. MacLaury had suggested. Accordingly, while he was concerned about the performance of the aggregates, he would defer actions to tighten the money market for a little while longer in the hopes that confidence could be rebuilt and that more positive indications of a recovery would materialize.

Mr. Holland said his views on monetary policy were colored by his judgment that the recession probably had hit bottom and a recovery had begun. However, the Committee could not yet proceed on the assumption that the recovery was assured; there was still much work to be done. A number of suggestions had been made

during the meeting about approaches to structural problems in the economy that warranted the commitment of staff resources around the System in the weeks and months ahead. Perhaps work could be undertaken along the lines of the housing studies of a few years ago to provide the basis for public statements by System officials.

However, Mr. Holland observed, current structural problems were not confined to the real economy. There were aspects of the financial structure that, by adding to costs, were likely to inhibit the rate of economic recovery. Some of those problems could be dealt with directly by the Federal Reserve. The Board often took regulatory actions--relating to reserve requirements, for example--without adequately considering their implications for the costs of doing business by banks and, indirectly, for the costs of credit to homebuyers and other borrowers. There were problems associated with the asset and liability powers of financial institutions--including, in particular, some real difficulties relating to bank capital and access to capital. The System should reinforce its efforts to deal with such problems, not only to further the kinds of objectives that were customarily considered when decisions on financial structure matters were made, but also to foster a noninflationary economic recovery. In his judgment, major gains could be made in that area.

While monetary policy also had a contribution to make, Mr. Holland continued, yesterday's discussion suggested that at present it had only limited room for maneuver. In his view the recent bulge in the monetary aggregates was a desirable development. The bulge was not at all worrisome to him since an examination of the data indicated that it was correlated with the bulge in Treasury tax payments. Moreover, with the extra social security payments due soon, there would probably be a few more weeks of rapid growth in the aggregates. In fact, it might well be August before movements in the aggregates ceased to be influenced by one-shot fiscal injections of funds and the data became more indicative of underlying trends.

The staff evidently believed that over the months ahead M_1 would grow at a rate in the neighborhood of 7 per cent if there were no further policy adjustments, Mr. Holland said. It was likely, although not certain, that that rate of monetary expansion was higher than the Committee could afford to tolerate for an extended period. Also, the role of broader measures of money in financing the recovery might increase relative to that of M_1. Nonetheless, he thought the Committee would be well advised not to make a major policy move before the August figures for the aggregates became available. In the interim he would be willing to accommodate whatever bulge took place.

Mr. Holland added that he did not think money market conditions should be permitted to ease. He anticipated some seasonal ripples over the next few weeks, but he did not think they would be serious. Because he believed that financial markets were measurably more stable than a month ago, he would not want to use a directive that emphasized money market conditions, like that issued in May; he would return to the type of directive used previously. He would be willing to provide for some upcreep in the Federal funds rate between now and the next meeting, mainly because it was always difficult for the Committee to alter its policy course and a small move now might make it easier to undertake a more substantial adjustment when it was needed later.

Mr. Baughman said it was important to keep in mind--and before the public--the notion that inflation was preponderantly a financial or monetary phenomenon, and that it was necessary to move toward a noninflationary rate of expansion in the monetary aggregates in order gradually to wring inflation out of the economy. The problem was complicated by the nation's objective of full employment and by the various institutional arrangements that made it difficult or impossible to achieve full employment without considerable upward pressure on the general level of prices. It was therefore necessary to focus attention

on the institutional arrangements that were inconsistent with price stability at full employment.

In the current situation, Mr. Baughman continued, he would subscribe in general to the policy outlined by Mr. Coldwell and endorsed by a number of other speakers. He would wait another month, or perhaps a little longer, to see how much of the bulge in the aggregates was due to fiscal developments and how much reflected emerging strength in the economy that the fiscal measures had been designed to foster. The Committee had hoped to see faster growth in the aggregates, although the members were undoubtedly surprised at the dimensions of the current expansion. If after another month or so the aggregates did not return to something approximating their earlier more moderate growth path, the Committee would have to conclude that their strength was due to more than the temporary impact of fiscal stimulus.

Mr. Baughman said he had the impression that banks and savings and loan associations remained anxious to add to their liquidity. That impression had been reinforced within the last few days when he had visited a number of Eleventh District banks that were relatively large by the standards of the District. Although those banks had fairly low loan-deposit ratios and were experiencing good inflows of funds, at present they were completely

satisfied to acquire short-term Governments; indeed, they were not even much interested in municipals. From their comments about the future, he inferred that they were not yet even thinking of stretching out beyond the bill area. In his judgment the strength of present liquidity preferences was another argument in favor of allowing the relatively rapid expansion in the aggregates to continue for another month or so before taking steps to slow it down.

Mr. Black said he shared the Chairman's assessment of the policy that the Committee had pursued over the past year; it had been proper and could be defended. At this point the policy issue was quite different from that at other recent meetings, when the Committee had been concerned with the magnitude of the reduction needed in the Federal funds rate to foster expansion in the monetary aggregates. Now that the economy was at--or past--a turning point and the aggregates were charging ahead, the policy question was one of timing: whether the Committee should act deliberately now to slow the aggregates, and if so how vigorously.

His intuitive feeling, Mr. Black continued, was that the staff had overestimated the likely upward pressures on interest rates. His guess was that the relatively slow rate of recovery projected by the staff, combined with economic weakness abroad,

would be associated with somewhat weaker demands for money and credit than the staff anticipated. One could easily be misled by the recent bulges in the aggregates, which were due in part to special factors, and he would guess that a significant slowing in the growth of the aggregates would occur in the months immediately ahead. In view of his assessment of the aggregates, of the lack of conclusive evidence that the recovery had begun--although, like Mr. Holland, he thought it probably had--and of the likely shock to markets of System action to move rates up at this stage of the cycle, he thought the Committee would be well advised to retain a bit longer the range for the Federal funds rate adopted at the previous meeting. As one director of the Richmond Bank had characterized the present situation, there were some sprouts of growth here and there, but they had to be cultivated like young plants if they were to prosper. He would add that one had to be careful not to overfertilize or to overwater young plants. If the aggregates continued to expand at excessive rates and if evidence of an upturn in economic activity continued to mount over the next several weeks, it would be appropriate for the Chairman to call a telephone meeting of the Committee or to send a wire to Committee members with a view to raising the range for the Federal funds rate.

Mr. Clay expressed the view that the excessive rates of growth in the aggregates might be related directly to greater-than-anticipated strength in the economy. Also, he thought recent declines in interest rates were at least partially the result of further downward revisions in anticipated Treasury borrowing; if so, an upturn in interest rates could be expected as the recovery gathered strength. The big uncertainty was whether the recovery would be sufficiently strong and durable to make significant inroads on available capacity. In view of that uncertainty, he would opt at the present time for a policy that would accommodate a healthy expansion in the economy. In deciding upon appropriate growth rates for the aggregates, he would take into account the cyclical increase in velocity that was to be expected during the expansion, which would tend to reduce the growth rate in money required.

Chairman Burns remarked that, in light of the emphasis that had been placed on interest rates during the Committee's discussion, it might be helpful if he were to review briefly certain historical experience with interest rates--specifically, that of the year 1972. The System had been criticized for pursuing an excessively expansionist policy in 1972, and he thought most Committee members would agree in retrospect that monetary expansion had been carried a little too far in that

year. He himself had made some public statements to that effect. It was instructive to compare changes in the Federal funds rate during the year with those in various long-term rates. The funds rate reached a low point in February of 1972 and rose in every subsequent month through the end of the year, registering a total advance of just over 2 percentage points during that interval. However, key indexes of corporate bond yields posted declines during the same interval: new issue rates on Aaa utility bonds fell 19 basis points; recently offered Aaa utility obligations declined 13 basis points; seasoned Aaa corporates declined 19 basis points; and Baa corporates declined 30 basis points. In the municipal bond market, the Bond Buyer index of twenty bonds was off 24 basis points over the period in question.

Chairman Burns said he drew a number of lessons from that experience. First, he thought the Committee had become excessively sensitive to minute changes in the Federal funds rate, forgetting that it was highly volatile. Second, the Committee tended to attribute to the Federal funds rate a degree of influence on long-term interest rates that it simply did not have. In reviewing developments in 1972, one might ask why the Federal funds rate had not risen by more than 2 percentage points. The answer, he thought, was that the Committee had been concerned about the possible consequences for interest rates in general.

Because of that concern, it had permitted the monetary aggregates to rise at rates that were now seen by most, and perhaps all, of the members to have been excessive.

The experience of 1972 needed to be kept in mind in present circumstances, the Chairman remarked. At times in the past Committee members had suggested following a monetary policy that would not rock the boat, and similar suggestions might well be advanced at the meetings in July and August. While he had much sympathy for that view, he was afraid the monetary aggregates would explode once again if the Committee remained unduly sensitive to small upward movements of the Federal funds rate. In his judgment, the recent high growth rates of the aggregates reflected an increase in the demand for money as well as the tax rebates, and there was a risk of overstressing the significance of the latter factor.

The Chairman then asked Mr. Partee for his views on monetary policy.

Mr. Partee said he could appreciate the concern that some members of the Committee had expressed about a firming in interest rates at such an early stage of the recovery--if indeed a recovery was under way--when economic resources were still greatly underutilized. He thought it would be perfectly legitimate to argue that, in order to encourage a vigorous recovery

in economic activity, short-term interest rates should be maintained at current levels through the summer and fall and into the winter, letting the monetary aggregates run. That sort of policy was being proposed by quite a few professional economists, and it was close to the approach the Committee itself would have favored a decade ago in considering the question of providing adequate financing for a cyclical recovery.

However, Mr. Partee continued, it had to be understood what "letting the aggregates run" would mean under current circumstances. The staff's projection of nominal GNP, which he thought was fairly firm, implied that holding short-term rates at present levels would probably result in double-digit rates of growth in the money supply over the next 6 months. The Committee had decided on certain growth objectives for the monetary aggregates over the next 12 months that were indexed by a growth range of 5 to 7-1/2 per cent for M_1. Constraining the growth of the aggregates within the ranges agreed upon probably would require a rise in short-term rates at a relatively early date. One often heard criticism of the proposition that System open market operations affected the demand for money--and therefore the rate of monetary growth--with a lag, but he had never found an acceptable substitute for it. In the present instance, he was concerned about the danger of falling behind

in the effort to achieve the Committee's longer-run targets for the monetary aggregates and of being forced sooner or later to make a sharp adjustment, perhaps an over-adjustment, in money market conditions to compensate for a major overshoot in the aggregates.

Accordingly, Mr. Partee observed, he thought the time was coming to consider some firming in the Federal funds rate as an opening move in what probably would be an extended period of generally rising short-term interest rates. The present month was not a bad time to begin because there were virtually no Treasury financings to inhibit System operations. Also, debt markets had been quite strong over the last several weeks and were now in a good position to absorb a little tightening. He viewed the blue book projection of M_1 for July as more than usually tentative; if the current bulge reflected mainly the temporary deposit of Treasury checks by individuals, monetary growth rates might well drop off more than was projected as the funds were spent. If the aggregates did turn out to be rather weak in July, he thought the Committee should welcome that development and not ease money market conditions and reserve availability. In particular, he would recommend June-

July ranges of tolerance for the aggregates something like those associated with alternative B in the blue book, but in keeping with Mr. Axilrod's suggestion he would reduce the lower limits of the ranges by, say, one percentage point. He had been thinking earlier in terms of a 1-1/2 percentage point reduction, but considering likely developments in June, that would have the undesirable implication that the Committee was willing to tolerate a zero rate of growth in M_1 for July.

Mr. Partee said he also would recommend that the Committee consider moving money market conditions very gradually in a tightening direction over the coming interval, unless considerable weakness occurred in the monetary aggregates. The Federal funds rate, which in recent days had been at around 5-1/4 per cent, might be moved up gingerly to a ceiling of 6 per cent. The bond market would react to such tightening initially, but if it were accomplished carefully and cautiously, bond yields would not necessarily rise over the course of the summer and early fall in view of the prospects for a declining rate of inflation. In the past, the early stages of cyclical recovery frequently had been marked by a rise in short-term rates and by stability or even some decline in long-term rates.

He saw no reason for thinking that such an experience would not be repeated during the initial stages of the current recovery.

Chairman Burns then asked the Committee members to indicate their preferences for the numerical specifications to be associated with the directive.

Mr. Debs said he thought it was time to move the Federal funds rate. His preference would be to set a range of 5 to 6 per cent and to have the Desk raise the rate to 5-1/2 per cent within a relatively short period of time. He would not pull back from that level unless it became clear that the aggregates were coming in very weak. On the other hand, if the aggregates were very strong, he thought it would be best to move very cautiously above 5-1/2 per cent in order to test market reaction. For the monetary aggregates, he would favor short-run ranges of tolerance indexed by a range of 6 to 9 per cent for M_1. He would also like to see 6-month growth rates keyed to 7 per cent for M_1 and about 9-1/2 per cent for M_2.

Mr. Francis said the long-run specifications associated with alternative C would fit his views on monetary policy. He

thought those specifications would also be consistent with the Committee's decision at the previous meeting in that their implementation over the next 9 months would result in M_1 growth--measured from the first quarter of 1975 to the first quarter of 1976--at the upper end of the range adopted at that meeting. With regard to the June-July ranges of tolerance for the aggregates, he would not be disturbed if the actual growth rates turned out a bit below the alternative C ranges. He thought the present would be a good time to focus a little more attention on the aggregates and to accept more market influence on the Federal funds rate; that influence, in his view, would not be very great over the month ahead. He was somewhat apprehensive about permitting front-end loading in light of the prospective future need to reduce the growth of the aggregates at a time when market interest rates might be under strong upward pressure.

Mr. Morris said he found heartening--indeed, a bit surprising--the willingness of most people around the table to move the Federal funds rate. In present circumstances, however, he thought it would be premature to raise the rate. He would feel differently if the earlier shortfalls in the aggregates had been more nearly made up. He would support all of the specifications associated with alternative A.

Mr. Kimbrel said he too was encouraged by the willingness

of Committee members to allow more movement in the Federal funds rate, but unlike Mr. Morris he hoped the Committee would begin the firming process at this meeting. Alternative B appealed to him, although he would amend the numerical specifications associated with that alternative to include a tolerance range for M_1 of 6 to 9 per cent for the June-July period and an inter-meeting range of 5 to 6 per cent for the Federal funds rate. He would raise the funds rate in a gradual and probing manner within the range in order not to upset financial markets.

Mr. Baughman said he favored the specifications of alternative B, except that he would prefer a range of 5-1/4 to 6-1/4 per cent for the Federal funds rate. He could go along with the proposed reduction of the lower limit of the June-July range for M_1, although he would not consider that change to be essential.

Mr. Eastburn indicated that he would favor the specifications associated with alternative A, modified to include a 7 to 10 per cent range of tolerance for M_1 over the June-July period. He would make full use of the 4-3/4 to 5-3/4 per cent range for the Federal funds rate if the aggregates were coming in strong. He would also return to directive language that gave primary emphasis to the aggregates.

Mr. Balles observed that he would favor the specifica-

tions of alternative B, with one exception. He was not convinced that it would be necessary to have a Federal funds range of 5-1/2 to 6-1/2 per cent to keep the aggregates within the ranges specified under alternative B. For that reason, he would suggest a range of 4-1/2 to 6 per cent and he would move the rate up very gingerly, if at all, over the month ahead.

Mr. Winn expressed a preference for the alternative B specifications for the aggregates and a Federal funds range of 5 to 6 per cent.

Mr. MacLaury said he would endorse Mr. Partee's suggestion that the Committee adopt the alternative B ranges for the aggregates with the lower limits reduced by one percentage point. Because a turning point was at hand, he would set a narrow intermeeting range of 5 to 6 per cent for the Federal funds rate. In his view, the Desk should be free to use that range in the customary fashion rather than being limited to small, probing changes.

Mr. Coldwell indicated that he would prefer to make no major changes. He would widen the June-July ranges for the aggregates to include a 7 to 10 per cent range of tolerance for M_1, and he favored a 4-7/8 to 5-7/8 per cent range for the funds rate.

Mr. Mayo said he favored a range of 7 to 10 per cent

for the 2-month growth rate in M_1 and a Federal funds rate range of 5 to 6 per cent.

Mr. Wallich indicated that he favored the alternative B range of 5-1/2 to 6-1/2 per cent for the Federal funds rate. He would reduce the lower limit of the 2-month ranges for the aggregates, setting a range of 6-1/2 to 9-1/2 per cent for M_1.

Mr. Clay said he would opt for alternative B, amended to include a 5-1/4 to 6-1/4 per cent range for the Federal funds rate. Over the coming 6 months he would like to see M_1 grow at a rate of about 6-1/4 per cent.

Mr. Holland indicated that the alternative B ranges for the aggregates, with some reduction in the lower limits, would be satisfactory to him. However, he would employ operating tactics somewhat different from those contemplated by that alternative in that he would set the range for the Federal funds rate at 5 to 5-7/8 per cent. It was quite likely that such specifications would necessitate an inter-meeting consultation with the Committee. Nonetheless, he would not want a larger movement in the Federal funds rate without giving the members an opportunity to weigh its market consequences. If an increase to the 5-7/8 per cent upper limit did not appear to upset financial markets, he would be prepared to raise the rate further, if necessary.

Mr. Black said he would favor the alternative B specifications for the 2-month aggregate growth rates, with the lower limits reduced by one percentage point. For the Federal funds rate he would prefer a range of 5-1/4 to 5-3/4 per cent, and he would be inclined to stay at the lower end of that range. If the aggregates continued to spurt and there was some confirmation of an economic upturn, he would favor a special meeting of the Committee and would be prepared to move the rate up promptly at that time.

Mr. Bucher expressed a preference for the alternative A specifications for the aggregates and noted that he would have no objection to reducing the lower limit of the range for M_1 to 7 per cent. More importantly, however, he would retain the 4-1/2 to 5-1/2 per cent range for the Federal funds rate adopted at the previous meeting.

Mr. Mitchell said he would set a 5 to 6 per cent intermeeting range for the Federal funds rate and a 6 to 10 per cent 2-month range of tolerance for M_1.

Chairman Burns asked whether the language of alternative B was acceptable to the Committee for the operational paragraph of the directive. A majority of the members indicated that that language was acceptable.

The Chairman then observed that a majority of the

members appeared to favor the June-July growth ranges for monetary aggregates shown under alternative B, with the lower limits reduced. He would suggest a range of 6-1/2 to 9-1/2 per cent for M_1--which would involve a reduction of one percentage point in the lower limit shown under alternative B-- and ranges for the other aggregates consistent with that range for M_1.

In response to a question, Mr. Axilrod said he would recommend that the Committee accept 2-month ranges of 9 to 12 per cent for M_2 and 5 to 8 per cent for RPD's as consistent with a 6-1/2 to 9-1/2 per cent range for M_1.

A majority of the members indicated that such ranges would be satisfactory.

Chairman Burns then asked the members to indicate whether, for the inter-meeting Federal funds rate range, they preferred a lower limit of 5 or 5-1/4 per cent, and an upper limit of 6 or 6-1/4 per cent.

A majority of the members indicated that they preferred lower and upper limits of 5 and 6 per cent, respectively.

Mr. Holmes noted that it had been suggested by several members during the discussion that the funds rate should not be permitted to fall below its current level unless the aggregates appeared to be quite weak. He would like to have clarification

of the Committee's intentions on that point.

The Chairman observed that the funds rate was now close to the middle of the 5 to 6 per cent range. He would propose that the Desk operate under the customary rules, without any special admonitions or interpretations; in other words, that it be prepared to use the full range.

Mr. Eastburn said it would be fairly important to him to know how vigorously the Desk might move the funds rate up if a rise appeared to be indicated.

Chairman Burns replied that he would expect the Desk to move the funds rate gradually in one direction or the other, depending on the week-by-week flow of information regarding the aggregates. That was the customary procedure.

Mr. Holmes remarked that any resulting increases in the funds rate might have a greater effect on long-term markets than now anticipated. Presumably, if there were highly adverse effects on long-term rates, the Desk would be expected to consult with the Chairman about the appropriate course of action.

The Chairman agreed. He added that if the problem appeared to him to be a difficult one he would quickly consult with the Committee.

Chairman Burns then proposed that the Committee vote on a directive consisting of the general paragraphs as drafted by

the staff and alternative B of the drafts for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The ranges of tolerance for growth rates in the June-July period would be 5 to 8 per cent for RPD's, 6-1/2 to 9-1/2 per cent for M_1, and 9 to 12 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 5 to 6 per cent.

With Messrs. Bucher and Coldwell dissenting, 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 suggests that real output of goods and services--after having fallen sharply for two quarters--has leveled off in the current quarter. In May retail sales strengthened considerably. Industrial production declined slightly further, but total employment advanced for the second consecutive month. The unemployment rate increased again, from 8.9 to 9.2 per cent, as the civilian labor force rose substantially further. The rise in average wholesale prices of industrial commodities continued to be slow; prices of farm and food products increased moderately further. The advance in average wage rates so far this year has been considerably less rapid than the increase during the second half of 1974.

The foreign exchange value of the dollar has changed little since mid-May. The U.S. foreign trade balance continued in substantial surplus in April, but

at a rate much reduced from the first quarter. After large net outflows in the first quarter, there was a small net inflow of funds through banks in April, as liabilities to foreigners rose more than claims.

Growth in M_1, M_2, and M_3 was substantial in May, reflecting in part large Federal income tax rebates deposited at both banks and nonbank thrift institutions. Business demands for short-term credit both at banks and in the commercial paper market remained unusually weak, while demands in the long-term market continued very strong. Market interest rates in general changed little during the latter part of May, but since then rates in longer-term markets and on Treasury bills have declined. Mortgage rates have eased over the past month.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

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

Chairman Burns then suggested that the Committee consider a recommendation of the Manager regarding the guidelines for System operations in issues of Federal agencies, contained in a memorandum dated March 10, 1975.[1] He asked Mr. Holmes to comment.

Mr. Holmes said he thought the guidelines for operations in agency issues, originally adopted in August 1971 and subsequently amended from time to time, had served System objectives very well. The Desk had not found it necessary to undertake operations in special support of any area of the agency market. Operations in agencies had furthered, not interfered with, basic reserve objectives, and the System had not become the dominant factor in the market. Since 1971 the agency market had developed substantially.

As noted in his memorandum, Mr. Holmes continued, over the year 1974 System holdings of agency issues had increased by $2.8 billion--roughly $1 billion more than the rise in holdings of Treasury notes and bonds and more than double the rise in Treasury bills. However, the range of activity in agency issues could soon be inhibited by guideline number 5, which limited System holdings of any one issue to 20 per cent of the amount of that issue outstanding, and of the issues of any one agency to 10 per cent of the aggregate of that agency's outstanding issues. As of the date of the memorandum, there were 25 agency issues for which the

1/ A copy of this memorandum has been placed in the Committee's files.

remaining leeway for purchases was less than $20 million. The consequence of exhausting the leeway for particular issues was that the Desk might have to turn down attractively priced offerings in favor of others that were less attractively priced. In his judgment the general policy of buying securities at "best prices" was a highly important aspect of System operations.

In his memorandum, Mr. Holmes observed, he had recommended that the limits on holdings be increased to 35 per cent for any one issue and to 20 per cent for the issues of any one agency. He understood, however, that increases of that magnitude were considered by some to represent an unduly broad liberalization of the guideline. Accordingly, he would like to offer an amended recommendation, calling for increases in the two limits to 30 and 15 per cent, respectively. Those figures would give the Desk ample leeway for operations at present and could always be reconsidered should they become a handicap to operations.

In response to the Chairman's request for comment, Mr. Axilrod said he and Mr. Partee believed that increases of the magnitude originally recommended by Mr. Holmes were not essential at this time, since the agency market had recently been growing more slowly than earlier and since it appeared that there would be a growing supply of Treasury coupon issues to accommodate Desk purchases outside the bill area. In their judgment the smaller increases Mr. Holmes now proposed would be entirely appropriate.

In reply to a question by Mr. Holland, Mr. Holmes said the Desk had sold agency issues on only one or two occasions since operations in such issues were initiated in 1971.

Mr. Holland then remarked that he was opposed to the Manager's recommendation. He thought that the leeway for purchases should be increased at a later point in the economic recovery when the supply of new agency issues could be expected to be large, and that in the interim the Desk should engage in occasional sales of such issues as well as purchases. For various reasons, it was undesirable for the System to confine its operations in agencies almost exclusively to purchases.

Mr. Mayo said he disagreed with Mr. Holland's view that the recommended increase in the leeway should be deferred. In his judgment, the present was an appropriate time to make the change.

Mr. MacLaury said he saw merit in the argument that the Desk should not be prevented from buying numerous individual agency issues, however attractive their prices, because of leeway considerations. He wondered, however, whether the Manager would expect over time to use up any increase in the leeway the Committee might approve, necessitating another increase later, or whether he would generally expect to maintain the present relationships between System holdings and total outstandings.

Mr. Holmes replied that the purpose of the recommendation was to obtain needed flexibility in day-to-day operations, and not to facilitate an acceleration of operations in agency issues. In light of the fact that Federal agencies were not issuing new debt in any great volume at present, System acquisitions were much smaller than they had been last year.

In reply to a question by Mr. Mitchell, Mr. Holmes said he believed that the Desk had not sold any Treasury coupon issues within the past decade.

Chairman Burns remarked that it would be an excellent idea for the System to make sales of coupon issues from time to time. He agreed that on balance it should be a net purchaser, partly because of the possible marginal influence on long-term interest rates and partly because of the interest on the part of members of Congress, as expressed in the Concurrent Resolution. It was a mistake, however, for the System to confine itself solely to purchases.

Mr. Holmes said he shared that view. He thought, however, that unless careful advance preparations were made, the initial sale was likely to create considerable disarray in the market.

Chairman Burns observed that the initial sale might well be a delicate operation. Nevertheless, the desirability of making sales from time to time should be borne in mind.

With Mr. Holland dissenting, number 5 of the guidelines for the conduct of System operations in Federal agency issues was amended to read as follows:

5. System holdings of any one issue at any one time will not exceed 30 per cent of the amount of the issue outstanding. Aggregate holdings of the issues of any one agency will not exceed 15 per cent of the amount of outstanding issues of that agency.

The Chairman then noted that the Subcommittee on the Directive had submitted a revised version of its "first stage" report on March 11, 1975, and that he had offered a suggestion with respect to that report in a brief memorandum to the Committee dated June 2, 1975.[1/] He invited Mr. Holland to comment.

Mr. Holland remarked that the Subcommittee had divided its work into three stages, the first of which consisted of an evaluation of alternative reserve measures that might serve as short-term operating targets. The Subcommittee concluded that nonborrowed reserves were the best measure for the purpose, and it recommended that the FOMC shift from RPD's to nonborrowed reserves. It also suggested that the staff materials relating to prospective movements in nonborrowed reserves include a careful analysis of the assumptions relating to various elements in the reserve equation, including member bank borrowings.

1/ Copies of the documents referred to have been placed in the Committee's files.

Until such time as the FOMC was prepared to act on that recommendation, Mr. Holland continued, the Subcommittee proposed that the staff be authorized to include figures on nonborrowed reserves as "shadow" targets in the section of the blue book that set forth policy alternatives. That procedure would give FOMC members an opportunity to become more familiar with prospective patterns of change in nonborrowed reserves--even though it would not constitute a formal test of that series for target purposes, since the Desk would not in fact be aiming at particular levels of nonborrowed reserves. All of the members of the Subcommittee--including Messrs. Balles, Morris, and Wallich, in addition to himself--believed that it would be useful to proceed in that manner, particularly since the issue of short-term operating targets was not one that demanded immediate attention. The Chairman had noted in his memorandum of June 2 that he also believed it would be useful for the Committee to "track" nonborrowed reserves for a time before deciding whether to employ that variable as a target, and he had suggested that the FOMC plan on discussing some time in the fall whether to use nonborrowed reserves in actual operations in place of RPD's.

If the FOMC decided to follow that course, Mr. Holland remarked, the members would no doubt find that they were developing views on nonborrowed reserves as the tracking experiment

proceeded. The Subcommittee would be grateful if the members would share with it such thoughts, as well as any reactions they might have to particular parts of the first-stage report.

There was general agreement with the proposal that non-borrowed reserves be employed as a "shadow" target at this time, with a view to considering some time in the fall whether to use that variable as a short-run operating target.

The Chairman then noted that the second report of the staff committee on repurchase agreements had been distributed on May 13, 1975.[1] He asked Messrs. Axilrod and Sternlight to comment.

Mr. Axilrod said he would limit himself to the observation that the three members of the staff committee--Messrs. Scheld, Sternlight, and himself--were unanimous in the recommendation that the Desk be authorized to make repurchase agreements with bank as well as with nonbank dealers.

Mr. Sternlight observed that in its May 13 report the staff committee reviewed experience during the period since April 1972, when the Desk began arranging repurchase agreements with nonbank dealers on a competitive basis, and concluded that competitive bidding had worked well. The staff committee also renewed

1/ A copy of this report has been placed in the Committee's files.

its earlier recommendation that the Desk be authorized to make RP's directly with bank dealers, mainly to broaden the scope of System RP's. While bank dealers now could, and did, participate in System RP's indirectly, by providing collateral through nonbank dealers, some were reluctant to do so. Moreover, bank dealers would be able to put the Desk in touch with a broader range of customers than now provided collateral through nonbank dealers.

Mr. Sternlight remarked that in the past one reason for System reluctance to make RP's with bank dealers was that member banks had access to the discount window. However, that argument was based on the questionable premise that the System was conferring a favor on dealers when it offered RP's. That premise was particularly weak under competitive bidding. The Desk offered RP's when it suited the System's reserve management purposes, and the funds went to the highest bidder at rates that might be above or below the discount rate, depending on prevailing monetary conditions. If direct access to RP's for bank dealers could increase the breadth of interest in bidding for System funds, it appeared to the staff committee that there was no reason not to provide that access.

Mr. Sternlight noted that repurchase agreements were covered by paragraph 1(c) of the Authorization for Domestic Open Market Operations. If the FOMC concurred in the staff committee's

recommendation that RP's be authorized with bank as well as with nonbank dealers, it could accomplish that purpose by deleting the word "nonbank" in the phrase designating the dealers with which RP's were authorized.

Mr. Mitchell observed that a member bank that was not a dealer bank would continue to have access to System funds only through the discount window--at rates that often would be higher than the RP rate--or by participating in RP's indirectly, through a bank or nonbank dealer.

Mr. Holmes noted in that connection that nondealer banks could participate in System RP's through dealers without great cost; in the interest of accommodating customers, dealers tended to charge only small commissions or none at all for the service.

Mr. Coldwell remarked that he did not care much for the practice of providing and withdrawing large volumes of funds temporarily through RP's and matched sale-purchase transactions. He asked whether the action proposed would encourage greater use of RP's by the Desk.

Mr. Holmes replied that in his judgment the effect of the proposed action would not be to encourage greater use of RP's, but rather to produce better rates on the RP's that were made by broadening the range of direct and indirect participants in the bidding. He added that the Desk recently had found it necessary

to arrange RP's and matched sale-purchase transactions on a large scale primarily to offset the marked fluctuations in the Treasury's balance at the Reserve Banks. The main hope for reducing the scale of such operations lay in a restoration of arrangements that would provide some measure of stability to the Treasury's balance.

Mr. Holland said he favored authorizing RP's with bank dealers, partly because one argument against doing so that had been pressed strongly in the past had been weakened if not removed altogether by recent events. He had in mind the argument that, since bank dealers had the benefits of tax and loan account credits in which nonbank dealers did not share, it was reasonable to limit the benefits of RP's to nonbank dealers. However, the value of tax and loan accounts to banks had been sharply reduced by the recent reduction in the average volume of funds the Treasury held in such accounts, and would be reduced even more under the Treasury's legislative proposal for earning interest on tax and loan account balances.

After some further discussion, the Committee agreed that it would be desirable to authorize RP's with bank dealers.

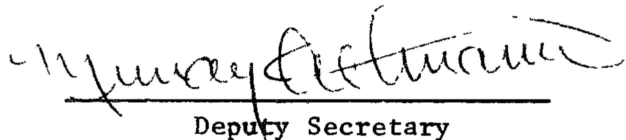
By unanimous vote, paragraph 1(c) of the Authorization for Domestic Open Market Operations was amended to read as follows:

(c) To buy U.S. Government securities, obligations that that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United

States, and prime bankers' acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers' acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

It was agreed that the next meeting of the Committee would be held on July 15, 1975.

Thereupon the meeting adjourned.



Deputy Secretary

ATTACHMENT A

June 16, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 16-17, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services--after having fallen sharply for two quarters--has leveled off in the current quarter. In May retail sales strengthened considerably. Industrial production declined slightly further, but total employment advanced for the second consecutive month. The unemployment rate increased again, from 8.9 to 9.2 per cent, as the civilian labor force rose substantially further. The rise in average wholesale prices of industrial commodities continued to be slow; prices of farm and food products increased moderately further. The advance in average wage rates so far this year has been considerably less rapid than the increase during the second half of 1974.

The foreign exchange value of the dollar has changed little since mid-May. The U.S. foreign trade balance continued in substantial surplus in April, but at a rate much reduced from the first quarter. After large net outflows in the first quarter, there was a small net inflow of funds through banks in April, as liabilities to foreigners rose more than claims.

Growth in M_1, M_2, and M_3 was substantial in May, reflecting in part large Federal income tax rebates deposited at both banks and nonbank thrift institutions. Business demands for short-term credit both at banks and in the commercial paper market remained unusually weak, while demands in the long-term market continued very strong. Market interest rates in general changed little during the latter part of May, but since then rates in longer-term markets and on Treasury bills have declined. Mortgage rates have eased over the past month.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with substantial growth in monetary aggregates over the months ahead.

Alternative B

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with a slowing of growth in monetary aggregates over the months ahead.

ATTACHMENT B

June 17, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed 6/17/75)
. Desired longer-run growth rate ranges: (June '75 to June '76)	M_1	5 to 7-1/2%
	M_2	8-1/2 to 10-1/2%
	M_3	10 to 12%
	Proxy	6-1/2 to 9-1/2%
. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (June-July average):		5 to 8%
2. Ranges of tolerance for monetary aggregates (June-July average):	M_1	6-1/2 to 9-1/2%
	M_2	9 to 12%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		5 to 6
4. Federal funds rate to be moved in an orderly way within range of toleration.		

5. Other considerations: account to be taken of developments in domestic and international financial markets.

- 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.