MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, June 29, 1971, at 9:30 a.m.

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

Mr. Swan, Alternate Member of the Federal Open Market Committee

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Garvy, Gramley, Hersey, Scheld, Taylor, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Leonard, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors

Mr. O'Brien, Special Assistant to the Board of Governors
Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Bryant, Associate Adviser, Division of International Finance, Board of Governors
Mr. Zeisel, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Messrs. Melnicoff, MacDonald, Fossum, and Strothman, First Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, Atlanta, and Minneapolis, respectively
Messrs. Parthemos and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond and San Francisco, respectively
Messrs. Willes, Hocter, Jordan, Nelson, and Green, Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, St. Louis, Minneapolis, and Dallas, respectively
Mr. Anderson, Assistant Vice President, Federal Reserve Bank of Boston
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period June 8 through 23, 1971, and a supplemental report covering the period June 24 through 28, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs observed that since the Committee's last meeting various actions had been initiated to deal with the consequences of the German decision to float the mark. The System's swap debt in Belgian francs had been cut from $490 to $340 million by a Treasury drawing of $150 million Belgian francs from the International Monetary Fund. Similarly, the previous swap debt of $250 million in Dutch guilders had been cleared away by a Treasury drawing of $100 million of guilders from the Fund, plus an earlier sale of $150 million of special drawing rights to the Dutch. Last Thursday, the German Federal Bank had agreed to invest $5 billion in special Treasury securities in the one-to-five-year range; $3 billion was so invested last Friday (June 25), mainly through liquidation of shorter-term special securities held by the Federal Bank, and the remaining $2 billion would be invested over the next week or so. At the July meeting of the Bank for International Settlements, the Bank's Board of Management would consider a U.S. Treasury offer of special investment facilities to facilitate a shift of central bank deposits with the BIS from the Euro-dollar market, to the extent that such a shift was deemed desirable by the Group of Ten countries involved. He thought the chances were pretty good that the BIS Board would accept the Treasury's offer; if so, machinery would be available for open market operations in either direction in the Euro-dollar market.

Mr. Coombs said some of the recent mopping-up operations had involved a heavy cost in terms of Treasury reserve assets, and further reserve losses over the next month or so were likely to result from French and British prepayments of debt they owed to the Fund. Fortunately, there had been no signs so far that the Treasury's reserve losses were inducing precautionary conversions of dollar reserves by other central banks.

On the exchange markets, Mr. Coombs continued, the most striking feature of recent developments had been the lack of buoyancy in the European currencies that had been considered possible candidates for revaluation. After having been dragged up by the mark, the guilder had fallen back to a level less than 1 per cent above its previous ceiling as the market had realized that the abnormally large current account deficit of the Netherlands would hardly justify a revaluation of the guilder. Similarly, the Belgians had succeeded in sticking to the normal margins around parity. In fact, following official action to limit Belgian bank borrowing in the Euro-dollar market, the Belgian franc had fallen back almost to parity, and it was currently quoted well below the ceiling.

In the case of the mark, Mr. Coombs observed, in an effort to mop up domestic liquidity the German Federal Bank had been reluctantly paying off the speculators at a profit rate of 3-1/2 per cent on roughly $2 billion sold back to the market. Such dollar sales were, of course, propping up the mark rate which otherwise probably would have fallen back close to its previous ceiling. In general, earlier visions of a quick and substantial revaluation of the mark had been fading away. In that connection, it was worth noting that Germany had slipped into a current account deficit in April, just on the eve of the decision to float. There was also increasing awareness in the market that German industrial wages had risen by 18-1/2 per cent in 1970 on top of the 9.3 per cent revaluation of the mark in late 1969. Over the past six months, industrial wholesale prices in Germany had risen at an annual rate of 7 per cent. The decisive factor leading up to the floating of the mark had been German industrial borrowing abroad. During the three months from February to April of this year, according to the latest monthly report of the German Federal Bank, such borrowing had amounted to $2-3/4 billion, or as much as the entire German banking system had lent to its domestic customers during the same period.

Mr. Coombs commented that the floating of the mark on the basis of German borrowing abroad had been costly not only to the United States but also to the Common Market. Strong pressures were therefore building up in the Common Market for some compromise arrangement under which German insistence on more exchange rate flexibility vis-a-vis the dollar would be accepted in exchange for German controls on industrial borrowing abroad. While the German Government remained opposed to administrative controls over German industrial borrowing along the lines of the French or British models, there were reports that an alternative control technique imposing some kind of uniform reserve requirements on German non-bank borrowing abroad might prove acceptable. The concession Germany was seeking from its Common Market partners in the exchange rate flexibility area might perhaps take the form of a moderate widening of the margins, perhaps to an over-all band of 3 or 4 per cent as against the present 1.5 per cent.

Mr. Coombs thought it was fair to say that most of the Foreign Department men in the European central banks had felt for many years past that such a moderate widening of the band against the dollar--from 1.5 to, say, 3 per cent--would give them more room for maneuver in dealing with speculation and would be unlikely to have any seriously destabilizing consequences. As the Committee would recall, however, the Common Market countries had only recently completed plans for a narrowing of the margins among their currencies. A simultaneous widening of the band against the dollar and a narrowing of the band within the Common Market would present some formidable technical problems and the Common Market might well be forced to choose one or the other. However that policy issue might be resolved, German agreement as part of the bargain to impose controls on industrial borrowing abroad would represent a long step forward.

Mr. Brimmer asked Mr. Coombs to comment on the reasons underlying Britain's plan to prepay debt to the Fund, and on the possible implications of that action for the dollar.

In reply, Mr. Coombs noted that a good part of the recent dollar inflows to Britain undoubtedly involved "hot" money that could quickly flow out again. Accordingly, there was an advantage to the British in repaying debt to the Fund now, since that would enable them to borrow again if necessary. As to the implications, since the Fund was not in a position at present to accept dollars, in order to make the prepayment the British would have to buy other currencies--notably Belgian francs and Dutch guilders, of which the Fund's supplies were short. There was considerable risk that the dollars the British used to purchase those currencies would in turn be presented to the U.S. Treasury for conversion into gold or SDR's. The amount of the British prepayment could be substantial--perhaps as much as $600 million. In addition, the French would be making a repayment--as a consequence of a Fund ruling--that probably would cost the Treasury $200 million in gold.

By unanimous vote, the System open market transactions in foreign currencies during the period June 8 through 28, 1971, were approved, ratified, and confirmed.

Chairman Burns then invited Mr. Daane to report on developments at the meetings in Europe he had attended in mid-June.

Mr. Daane noted that the standing committee on the Euro-dollar market had met in Basle on the afternoon of June 12, primarily for the purpose of agreeing on the report to be presented for consideration by the governors at their meeting on June 13. The report consisted of four parts, of which the first was an analysis of statistics on the Euro-dollar market. The figures indicated that the G-10 countries had made negligible direct placements of funds in the Euro-dollar market; practically all of their placements were through the BIS. Their placements (plus those of the BIS itself) had amounted to about $3-1/2 billion, out of total official placements of perhaps $11 or $12 billion in a market with an estimated size of some $60 billion. Secondly, while recognizing that it was not possible to make precise quantitative assessments, the committee's analysis supported the conclusion that those placements by central banks had clearly contributed to the increase in reserves of the G-10 countries, and that they had complicated the credit restraint programs of a number of countries.

Third, Mr. Daane continued, the committee recommended that the G-10 countries continue to refrain from placing additional funds in the Euro-dollar market, and that they agree to a gradual and prudent transfer of earlier placements from that market back to the United States. At that point there had been some discussion of a

U.S. Treasury proposal to issue special Treasury securities to the BIS. However, no conclusion was reached other than a recognition that means could be found to provide suitable investment opportunities in the United States. The final part of the report concerned the future work of the standing committee, which would be meeting again on July 10. It was agreed that the committee should look into central bank swaps with commercial banks as a source of supply of dollars to the Euro-dollar market; the matter of official placements in the market by countries other than those in G-10; and the possibility of some regulatory measures, such as reserve requirements.

Mr. Daane observed that the committee's report was the only subject of discussion at the governors' meeting on the afternoon of June 13. The governors accepted the recommendations calling for agreement by the G-10 countries to make no new placements in the market and to undertake a gradual withdrawal of earlier placements as circumstances warranted. Some countries went along reluctantly, notably the French. They argued that the United States was responsible for recent developments, but that--while other countries were, in effect, entering into a contract not to put their funds into the market--the United States was not offering to do anything. Along with Mr. Hayes, he had tried to demonstrate that that was not the case. In particular, he had noted that at the April Basle meeting Chairman Burns had indicated that the United States stood ready to devise means to provide suitable investment outlets for the dollar holdings of the other countries involved--a step that was in their interest since the placement of those funds in the Euro-dollar market had complicated their problems of reserve management and credit restraint. While the French argued that there was still no assurance that funds so transferred to the United States would not find their way back to the Euro-dollar market, he had pointed out that that simply reinforced the need for "gradual and prudent" withdrawal.

Mr. Daane added that there had been considerable discussion at Basle of whether the standing committee's report and recommendations should be published. The French strongly opposed publication, and except for the British and the Americans most of the others also did not favor publication. The compromise finally reached was that in the speech Mr. Zijlstra was to make the next day, in connection with publication of the BIS annual report, he would indicate that agreement had been reached to make no further placements in the market and to undertake a gradual withdrawal of earlier placements as circumstances warranted. As the members may have noted, Mr. Zijlstra's statement to that effect was reported in the American press.

The Chairman then invited Mr. Hayes to add any comments he might have on the Basle meeting and to report the impressions he had received on his recent visits to various European central banks.

Mr. Hayes said he had little to add regarding the Basle meeting, except that Mr. Daane had handled his part of the discussion ably. Also, he might note parenthetically that both he and Mr. Daane had had an opportunity to stress to British officials the difficulties that would be posed for the United States by the proposed U.K. prepayment to the Fund. While the British understood the U.S. position, they in turn had a strong desire to clear up the debt.

In reply to a question by Chairman Burns, Mr. Hayes said the matter had been left unresolved. However, he would not be surprised if the British went ahead with the prepayment.

Mr. Hayes then said that in the very limited time at his disposal today he would touch only on one or two major problems that had come up for discussion at all of the four major European central banks which he had visited. The most pervasive problem was cost-push inflation. It was a matter of concern everywhere, and no one had found a satisfactory remedy. In Germany the price increases attributable to wage pressures were being reinforced by excess aggregate demand, although some of the private bankers looked on the business outlook less optimistically than the Federal Bank, stressing profit erosion and declining investment. Some hope was expressed that the floating of the mark would have a "shock effect" on the unions and businessmen, making for less costly wage settlements. However, that effect was not yet visible, and it might be worth noting that an opposite result had followed the 1969 mark revaluation. Monetary policy in recent months had been thwarted by the German Government's refusal to check German business borrowing abroad, but since the float the Federal Bank had not created any more liquidity through purchase of dollars.

Mr. Hayes observed that he had found the French attitude toward their inflation rather puzzling. Some officials took it quite seriously, while others--together with a good many private bankers--seemed to think of it as mild and manageable, even though consumer prices had recently been rising as fast as in the United States. The central bank spoke of the inflation as largely due to cost-push and saw no reason to try to use monetary policy to dampen it. In recent months the principal aim of monetary policy had been to keep domestic interest rates at levels that would not draw in foreign funds. Fiscal policy probably would be tightened; and there was a rather widespread view that the French Government was capable of forceful action against inflation as and when needed.

While there was strong cost-push inflation in Italy, Mr. Hayes said, the weak state of the economy, caused partly by widespread labor unrest, had led to deliberate efforts to stimulate business by means of monetary and fiscal policy--so far with very mediocre success. When he was in Rome the Italians had been preoccupied largely with interpretations of the recently completed local elections, the results of which were regarded as a sharp warning to the Christian Democratic party. He found a good deal of hope--and some expectation--that the best remedy for the wage-cost explosion lay in a popularly-backed crackdown by the Government on a great variety of labor abuses, with consequent improvements in productivity and business investment.

Mr. Hayes thought Britain had perhaps the most serious inflationary problem of the four countries he had visited. It was almost wholly of the cost-push variety, with price rises in the 8 to 10 per cent range, while business was decidedly stagnant. Monetary policy could be labeled "accommodative." The Bank of England had, of course, been pushing hard for an incomes policy. And although the Government had to date held to its position opposing such a move, that was thought by many observers to be due mainly to a tactical need to concentrate for the moment on parliamentary action on entry into the Common Market and on the new industrial relations bill. He had sensed a rather widely held view that in the not too distant future Britain would have to come to an effective incomes policy--one with teeth in it.

Naturally, Mr. Hayes continued, the recent--perhaps he should say the current--exchange crisis was the main topic of conversation in all the central banks. One could not escape the conclusion that the dollar's prestige had suffered seriously; and many study projects were under way on means whereby Europe could become less dependent on the dollar. At the same time, the realistic view in most countries was that an international currency such as the dollar fulfilled many vital needs and that an adequate substitute would be difficult to find. Thus, the central banks were searching for ways to mitigate the effects of large dollar inflows--or to reduce the inflows--and he, like Mr. Coombs, had been heartened by indications that the German authorities might soon impose restrictions on borrowing in the Euro-dollar market by German nonfinancial concerns. It went without saying that the Europeans were looking to the U.S. to produce a marked improvement in its balance of payments, and he tried to stress the point that that would call for effort on both sides. The firming of the short-term interest rate structure in the United States in the last couple of months was looked upon as distinctly helpful.

Mr. Coombs then noted that three System swap drawings on the National Bank of Belgium would mature soon. They were a $5 million drawing maturing July 26, 1971; a $20 million drawing maturing July 27; and a $75 million drawing maturing August 3.

All would have been outstanding six months by their maturity dates, and the Belgian Bank had taken the position that drawings should not run beyond such a period. He expected that arrangements would be made for their repayment through a Treasury drawing on the Fund. It was possible, however, that an additional week or so beyond the maturity dates might be needed to complete those arrangements. Accordingly, he would recommend that the Committee approve renewal if necessary. Express action by the Committee was required under the terms of paragraph 1D of the foreign currency authorization, since the System had been making continuous use of the Belgian line since June 30, 1970.

> By unanimous vote, renewal if necessary of the three System drawings on the National Bank of Belgium maturing in the period July 26-August 3, 1971, was authorized.

Mr. Coombs then noted that three System drawings on the German Federal Bank, totaling $60 million, would mature for the first time on August 6, 1971. Those drawings had originally been made in connection with forward operations in marks which the System had conducted earlier in cooperation with the German authorities. He recommended their renewal.

> Renewal of the three System drawings on the German Federal Bank maturing on August 6, 1971, was noted without objection.

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

Mr. Partee made the following introductory statement:

Our main purpose today is to present the staff's new economic and financial projection, which has been extended for the first time out to mid-1972. The general pattern of the projection contains few surprises. We have dropped our previous assumption of a 60-day steel strike this summer, the chief effect of which is to smooth out the quarterly pattern of increases in GNP. Much more important, however, we now allow for a significantly higher rate of inflation this year and on into 1972 than we had been projecting earlier. This is in recognition of the sustained high rates of increase in employee compensation experienced throughout the recession phase and still seemingly in prospect.

In general, we see the economic recovery gradually developing added cyclical strength as time passes, though real growth still promises to fall well short of the vigor needed to reemploy a significant part of our presently unutilized human and material resources. The proximate cause of the continued relatively slow recovery is our expectation that neither desired rates of inventory accumulation nor business capital investment is apt to show the strength of previous cyclical recoveries during the forecast period. Perhaps the more basic consideration, however, is the improbability that real consumption will expand sufficiently to begin to tax our productive capacity or to induce any major enlargement of present goods pipelines. In view of the outlook for only moderate economic growth and the associated persistence of high unemployment, we have also prepared--with the help of our econometric model--an alternative projection that incorporates a substantial dose of additional governmental stimulus centered in the fiscal area.

For our basic projection, we assume a high employment budget very slightly in deficit during both the second half of 1971 and the first half of 1972, as in the first half of this year. Total Federal expenditures on a national income accounts basis are nevertheless projected to rise $22 billion from fiscal 1971 to fiscal 1972, and we have specifically accommodated the probable current military pay bill, a Government-wide pay raise effective January 1, a social security benefits increase next year, and some kind of Federal jobs assistance legislation that will raise public service employment about 200,000 beyond what it otherwise might be by mid-1972. As for monetary policy, we have assumed growth in the money supply at a 9 per cent rate in the third quarter, falling back to 7 per cent on average thereafter. This seems consistent with interest rates remaining essentially where they are now, allowing for some near-term increase in short rates and a gradual downdrift in long-term yields.

Mr. Wernick made the following statement on the basic GNP projection:

Although broad indicators of economic performance have turned upward this year, the recovery so far has been weak and has lacked the widespread upward thrust characteristic of past cycles. For example, the index of industrial production, adjusted to exclude the auto and steel industries because of their transitory distorting influence, did not reach its low until February of this year. The small rise since then reflects mainly some pick-up in consumer goods industries and in materials output associated with stepped-up construction activity. Business and defense equipment output have not turned around as yet, and remain far below earlier levels.

Retail sales, excluding autos, have shown improvement in recent months but not the sharp upsurge that had been counted on by some to fuel a vigorous recovery. In real terms retail sales have on the average been running less than 2 per cent above a year ago. New orders for durable goods have remained on a plateau, in contrast to pronounced upturns in early stages of previous cycles. Nonfarm employment has moved up somewhat, but the gains have been insufficient to absorb additions to the civilian labor force, so that unemployment has remained high.

An appraisal of the developments in the key sectors of the economy, in the context of our policy assumptions, suggests that the recovery in GNP growth is likely to remain relatively moderate over the next four quarters. We are now estimating a rise of $20 billion in GNP this quarter or about 3 per cent in real terms, well below the rise in the first quarter when auto activity rebounded. In the final two quarters of this year, GNP increases are expected to be close to those in the second quarter. For the first half of 1972 prospects are for larger quarterly increases in GNP--about $26 billion a quarter--but a substantial part of this dollar gain is likely to reflect rising prices. A comparison of past changes illustrates the importance of high prices in GNP growth. In the first half of 1968 current-dollar GNP increases averaged about $20 billion a quarter but real growth was at a 6.5 per cent annual rate. In contrast, in the first half of 1972 substantially larger current-dollar increases are associated with real growth projected to average only about a 5 per cent annual rate.

The relatively moderate real growth in GNP projected over the next four quarters reflects in part our evaluation that the Federal Budget, as now constituted, will provide little added fiscal stimulus to the economy.

Even after assuming that the $2.7 billion military pay raise will be enacted and the President will sign the Public Employment Service Bill, total Federal expenditures are projected to increase 10 per cent in the next fiscal year--not much more than they did in the current fiscal year. Moreover, most of the rise is in grants to State and local governments and transfer payments, which typically have a relatively weak and uncertain short-run economic impact. Federal purchases of goods and services are expected to increase a little in fiscal 1972, after declining slightly over the past year.

Nor does the Budget for fiscal 1972 provide any significant economic stimulus from the receipts side; estimated revenue reductions resulting from tax reform legislation will be largely offset by increases in social security taxes. The large deficits in the budgets, both in this and next fiscal year, result mainly from shortfalls in receipts arising from the weakness in the economy. Thus, the high employment budget is still expected to remain in only very slight deficit over the projected period--an indication of neutrality in discretionary fiscal policy.

In the private sector we foresee neither a buildup in inventory investment nor a surge in capital spending comparable to past cycles. Inventory investment in the first half of the year has remained relatively weak, despite substantial accumulation of auto and steel inventories. Uncertainty as to the prospective strength of final demands and a desire to maintain liquidity appear to be the major factors limiting inventory accumulation. In the last half of the year inventory investment is expected to continue sluggish, reflecting in part the current high level of auto stocks and the prospective liquidation of steel inventories. In the first half of 1972, however, a noticeable improvement in inventory investment is projected in response to more favorable stock-sales ratios as final demands expand.

The cumulative real inventory growth we have projected--taking either 4 or 6 quarters from the end of 1970, which is assumed to be the current trough--is substantially less than in the comparable periods from the trough in previous cycles.

Recent surveys of plant and equipment spending suggest that excess capacity in manufacturing and the relatively weak outlook for sales will continue to depress capital spending in 1971. We do anticipate some pick-up in business fixed investment spending early next year. Liberalized depreciation schedules should begin to bolster capital expenditures; but more important, as rates of real growth expand, business attitudes--including the outlook for profits--are projected to improve considerably.

In real terms, however, spending for business fixed investment is likely to show little change this year and to increase only moderately in the first half of next year. As with inventories, projected cumulative real business investment over the six quarters from the trough compares unfavorably to previous recovery periods.

The quarterly gains in total consumer spending we have projected call for some further moderate improvement, reflecting increases in disposable income and a small decline in the saving rate. This seems consistent with recent retail sales trends and consumer survey data, which continue to suggest consumer uncertainty despite over-all gains in incomes and financial asset holdings. Rising prices and high unemployment levels have contributed to consumer pessimism; since both price trends and rates of unemployment in our projections remain highly unfavorable, we see little basis for anticipating any upsurge in consumer outlays and a sharp drop in the saving rate.

The upsurge in residential activity has been the single most important factor contributing to the economic upturn this year. We are projecting further increases over the next four quarters, but the rate of gain is expected to moderate substantially. Housing starts rise from an annual rate slightly over 1.9 million units this quarter to about 2.1 million units in the fourth quarter, and then level off next year. Consequently, housing expenditures from here on out are expected to add less to growth in aggregate activity than in recent quarters.

It is possible that housing activity could be less bouyant than projected next year in view of the recent back-up in mortgage interest rates and the steadily rising costs of building. However, we think that inflows of funds to the savings institutions will continue to be sufficiently large--along with support provided by the Federal housing agencies--to assure ample availability of credit to finance the starts levels we have projected.

We have also projected a continuing rapid expansion in State and local government spending over the next year. This mainly reflects the backlogs of facility needs built up in recent years when financing was too costly or not available. But increases in grants from the Federal Government should also help stimulate outlays for current operations.

Summing up, lacking a sharp turn-around in inventory investment and capital spending and with the consumer sector only moderately expansive, our projected rate of real GNP growth falls far short of the gains made over the six quarters from the trough in previous cycles. In the preceding cyclical recoveries, the unemployment rate has typically fallen by 1-1/2 to 2 percentage points in the first 6 quarters of recovery. By comparison, we are projecting a further rise in unemployment through the fourth quarter of 1971 to 6.5 per cent, and only a modest downturn thereafter.

Mr. Zeisel made the following comments on the implications of the projection for labor demand and for wages and prices:

We have projected an increase in employment of about 1-1/4 million over the next four quarters. This total is a substantial improvement over the past year--when there was virtually no increase--but it is still just short of that necessary to offset expected growth in the civilian labor force, much less to reduce the level of unemployment.

Our projections call for an increase of 1.4 million in the civilian labor force--including 300,000 scheduled to be released from the armed forces. This would be a slightly larger gain than during the past year, but still below the anticipated "normal" increase based on population and participation-rate trends, and well under the average increase of other recent years.

Additions to the working age population now are heavily concentrated among those aged 20 to 34, a group characterized by high participation rates. These young adults generally enter the labor force regardless of existing job opportunities and we expect that behavior to continue. On the other hand, we have assumed that participation rates for other groups will continue to be dampened by poor employment opportunities, particularly for younger and older workers.

It would be nice if the continued slack we foresee in the labor market offered promise of relieving pressures on wage rates significantly. Certainly past experience would suggest this should be the case.

There has been a consistent pattern in past recessions of substantial slowing of the year-to-year rise in compensation per manhour in cyclical slowdowns--even during the mini-recession of 1966-67. And yet, in the recent recession compensation per manhour, including fringes, has continued to rise at over a 7 per cent rate--close to the increase at the cyclical peak.

The picture isn't entirely bleak--some easing of wage pressures has been evident. Gains in construction wages, for example, have moderated somewhat over the last year, although the rate of increase remains close to 9 per cent. Wage increases have also slowed slightly in retail trade and in State and local government. On the other hand, in manufacturing, wage gains have begun to accelerate again as a result of recent large first-year settlements, and for the private nonfarm economy as a whole, average hourly earnings are rising about as rapidly as a year ago.

The reasons for the sustained rise in wages are complex and not entirely clear, but the momentum of the current wage-price spiral and the continuation of widespread inflationary expectations certainly appear to play a large role.

First-year wage increases negotiated recently in union contracts are still averaging about 10 per cent, reflecting in part a catch-up for past cost-of-living increases. In addition, deferred wage increases--that is, those negotiated in prior years to go into effect in 1971 and 1972--are in the 7-1/2 per cent range, some 2 percentage points higher than in 1970, and these figures largely exclude the impact of cost-of-living clauses. Unions are now widely calling for large wage increases over the life of contracts rather than just the large first-year catch-ups which were characteristic a few years ago. Also, open-ended cost-of-living clauses have become more common in contracts as a defense against continuing inflation. By the end of 1971, some 4 million workers are expected to be covered by cost-of-living escalators, an increase of about 50 per cent since 1969. In addition, an anticipated Federal minimum wage increase in early 1972 will also act to lift the rate of wage increases.

On the plus side, industries are facing a much smaller calendar of wage negotiations in 1972--about 3 million workers will be involved in major negotiations, some 2 million less than in 1971--which is likely to result in fewer huge first-year wage increases and therefore somewhat less upward pressure on wage rates. The persisting slack in the labor market may also be reflected in a moderate further slowing of wage increases in some sectors, particularly those less unionized. But on balance, we look forward to only a slight easing in the rise of compensation per manhour by mid-1972.

With growth in compensation per manhour holding firm, all of the improvement in unit labor costs achieved over this past year has stemmed from recovery of productivity growth. This is likely to continue to be the case. A somewhat improved rate of increase in unit labor costs--about 3 per cent--is expected early next year as real GNP begins to achieve a more rapid growth path. But the kinds of productivity gains which in the past have cut substantially into unit labor costs have generally been associated with much larger increases in real output than we are anticipating during the next year. With compensation per manhour still projected to rise at close to 7 per cent, we are projecting the rate of increase in unit labor costs to edge down only to about 4 per cent by the second quarter of 1972, compared with about 5 per cent in the second quarter of this year.

The comparatively large projected rise in unit labor costs, along with attempts by business to restore profit margins, suggests continued substantial upward price pressures. We are now projecting that the rate of increase of the fixed-weight deflator for gross private product will edge down only to about 4-1/4 per cent in the second quarter of 1972, from about 4-3/4 per cent this quarter.

Mr. Gramley made the following statement on the financial implications of the economic projection:

Mr. Partee noted earlier that our GNP projection is based on the assumption that the money stock will grow at a 9 per cent rate in the third quarter and at a 7 per cent rate thereafter. Total bank credit is projected to expand at about the same rate as the money supply. This reflects a belief that business loan demands will be comparatively weak, and that banks will not be scrambling for CD's, consumer-type time deposits, or nondepositary liabilities.

We do expect a marked slowdown in growth rates of nonbank savings accounts. Transfers of existing stocks of financial assets from market securities to depositary-type claims--motivated by the steep decline in short-term market yields that ended this spring--will soon be completed. And with short-term market interest rates projected to rise somewhat further this summer, the competitive advantage of nonbank savings accounts will be reduced. We are, however, considerably more bullish on the outlook for savings flows, mortgage credit, and housing than are some other agencies in Washington.

Let us turn now to the interest rate projections that underlie these savings flow estimates. We expect 3-month Treasury bill rates to be pushed up in coming months by heavy Federal borrowing, to a 5-1/4 to 5-1/2 per cent range. Thereafter, short-term rates may stabilize because, with the money supply growing only a little less rapidly than nominal GNP, velocity would increase much more gradually than is characteristic of cyclical upswings. However, we are projecting a slight decline in the corporate Aaa new issue rate--

to a range around 7-1/2 per cent by year-end. The basis for this optimism lies in the projected volume and pattern of credit demands.

The total of funds raised by all nonfinancial sectors has jumped sharply in the first half of 1971, according to present estimates, with both private and Federal borrowing (seasonally adjusted) having increased substantially. Over the year ahead, however, private borrowing is projected to fall--both absolutely and as a percent of private GNP. In fact, the ratio of private borrowing to GNP declines to about the average 1970 level, when mortgage borrowing was still being curtailed by the holdover effects of credit restraint in 1969.

The source of the projected decline in private borrowing is the diminished need for external funds by nonfinancial corporations. The flow of gross internal funds--including an allowance for accelerated depreciation--has already begun to rise, and our GNP projection implies a substantial further boost over the next year from increasing aggregate profits. Since capital expenditures--including inventory investment--rise a good deal less rapidly, the gap to be financed narrows markedly.

Even if corporations continue to add substantially to liquid assets, as we assume they will, the narrowing of the financing gap would permit total borrowing to decline. And this decline would carry through to a reduced volume of bond and stock issues; since short-term borrowing is already at very low levels. Thus, although corporations may continue to pursue conservative financial practices for a while longer, the capital markets finally seem likely to be in for a breathing spell.

Let me turn now to a question that has plagued us in developing our GNP projection--a question, I am sure, that bothers the Committee as much as the staff. Why is it that the very high recent growth rates of money, together with the relatively high growth rates projected, fail to produce a satisfactory real economic performance? Why does the real economy not show the vigorous growth that generally has characterized postwar recoveries?

One answer might be that the lags are longer this time, and that the recovery will gather more momentum as this next year unfolds than we have allowed for. This does not seem very likely, since the sector most responsive to monetary policy--housing--responded quickly to monetary ease. But it is, of course, possible that we have given this consideration too little weight in our GNP projection.

A second possible explanation is that there has been a shift in liquidity preference--an increase in desired holdings of money, given income and interest rates. That possibility is always difficult to judge. To obtain a rough assessment, we simulated the money demand equation in our quarterly econometric model for the last 6 quarters, using actual values of GNP and interest rates--the variables which the model uses to explain desired money holdings.

Actual increases in M_1 have, in fact, run above predicted increases in the past two quarters, although the predicted increases are also large. What the model seems to tell us is that a good part of the increase in M_1 this year can be explained by heavy transactions demands and by the lagged effects of declines in interest rates late in 1970. Nonetheless, there is still something left to be explained. Thus, there may have been some upward shift in the money demand function this spring, but the problem is that we don't know when, or if, it will shift back again.

Third, it seems to me that the effects of cost-push inflation on transactions demand for money are a factor of major significance in assessing how much real stimulus can be expected from a given rate of rise in nominal money. The contrast between growth rates of the nominal money stock and the real money stock in recession and recovery during this and the previous four business cycles is striking. In past cycles, real and nominal growth rates of money during the recession and early recovery phases did not diverge much, since prices were relatively stable. But our price experience this time has been so unfavorable that a significant part of the stimulative effect of increases in nominal M_1 has been eaten away. Growth in real M_1 over the past two quarters, however, has been substantial. And our projections for the coming year, moreover, imply more real monetary expansion than in the comparable stages of previous recovery periods, when real money balances generally declined for one or more quarters.

Basically, the explanation for the relatively sluggish cyclical response of production and employment that we expect, given recent and projected growth in real money balances, reflects our view that private demands will not show the strength characteristic of a typical recovery. A major source of this weakness, in my view, is in inventory investment. Projected inventory investment over the next four quarters falls far short of the thrust from this sector characteristic of past cyclical upswings. If inventory investment during the first six quarters of the current recovery were to follow the average experience of the past three cycles, making allowance for the increased size of the economy now, it would have to rise to a level of about $25 billion by the second quarter of 1972--a most unlikely event.

In some sense, our success in moderating recessions has come to haunt us. Having kept the recession from deepening and producing outright declines in inventories, we now lack the vigorous thrust from an inventory turnaround that, in the past, has triggered a cumulative recovery process.

Mr. Hersey then made the following statement on balance of payments developments:

Starting with the Board staff's projections for the U.S. domestic economy and the projections of foreign developments that I will mention shortly, and taking into account the recent bad news about U.S. imports, we are estimating a sharp decline in U.S. net exports of goods and services in the quarter just ending, to under $1/2 billion, annual rate, and we are projecting this balance at close to zero through the next four quarters.

The May figures for merchandise imports, which came in late last week, were greatly at variance with the relatively hopeful view of import trends that we and other agencies had been taking up till then, despite the disappointing evidence given by the April statistics. Though some month-to-month fluctuations can reasonably be expected, we now must assume that second-quarter imports will prove to be higher than the figures that were used in the Board staff's GNP estimates by at least $2 billion, annual rate. This would make them 16 per cent higher than in the second quarter of 1970, and we expect a further rise of at least 10 per cent by the second quarter of next year, to a rate of about $50 billion. Exports may then be about $47 billion.

During last year's recession there was no dip in imports of industrial materials and no slackening in the rise of finished manufactures imports. The strength of imports of materials in the latter half of 1970 was related, in part, to the easing of foreign supply and demand conditions for steel and other semi-manufactures. Following a pause in the first quarter, the value of materials imports (which, incidentally, include petroleum) was again rising strongly in April and May.

On the other side, exports of materials fell off in the latter half of 1970 and early this year, but appear likely to be rising toward the end of the year. New foreign orders for U.S. machinery seem to have passed a peak, but we expect a resumption of rising sales. These two categories account for less than three-fifths of total exports. Agricultural exports, running at over $8 billion in the present half year, are likely to fall off toward a $7 billion rate by a year from now. Commercial aircraft deliveries, now close to a $2 billion rate, may also be somewhat lower next year. The projected rise in total value of nonmilitary exports from the second quarter of this year to the second quarter of 1972 is only 8 per cent.

The export projections, which are close to those made recently by an interagency committee, take into account the likelihood that growth in economic activity abroad will be relatively moderate. Even in Japan, the industrial production rise over the next twelve months, projected at about 12 per cent, would be much less than the 20 per cent gains of many earlier years. In Canada, production was sluggish in March and April, but with strong fiscal and monetary stimulus now, industrial output there should rise by 7 or 8 per cent; demand for capital equipment should improve. In the European Economic Community, growth will be heavily influenced by developments in Germany. Last year's inventory-adjustment phase of the cycle in Germany is over, and the statistics show that since late last year a new upswing has been in process. In coming months, however, expansion will be restrained by Germany's tight money policy, which will be reinforced by the drain on bank liquidity caused by net capital flows out of Germany in excess of the current account surplus.

We expect that in coming months the German central bank will continue refusing to add to its reserves, while standing ready to sell dollars at rates it deems suitable; it can thus prevent a balance of payments surplus but can allow a deficit whenever hedgers and speculators want to move out of German marks. The German Federal Bank will thus be able to keep an upward pressure on German interest rates. The 3-month inter-bank money rate is now about 7 per cent, not very much above either British sterling market rates or Euro-dollar deposit rates. With U.S. rates substantially lower, incentives for U.S. investors to move funds to the Euro-dollar market still exist; and the reflux of hedge money from Germany may well go in part into Euro-dollars, supporting Euro-bank lending abroad, as well as into other currencies. It is thus uncertain how much benefit the U.S. balance of payments may get from the reversal of flows of funds sensitive to European exchange rates. It is encouraging that we apparently did get some inflow in the week ending last Wednesday.

At the very short end of the Euro-dollar market, the overnight rate has been below Federal funds in the last three weeks, pushed down by the reflux from the German mark. This is one reason why U.S. banks are no longer reducing their liabilities to foreign branches.

Until the German authorities succeed in their domestic stabilization efforts, the general level of interest rates in Europe is likely to remain well above the present U.S. level. Canadian rates, on the other hand, are at present relatively low in relation to U.S. rates; short-term rates are well below ours, and long-term rates are not as far above ours as usual.

The recent interagency projections of flows of long-term capital in the U.S. balance of payments take a rather optimistic view. The attempt to project these flows needs to take account not only of interest rate relationships, but also of the attitudes of foreigners toward dollar equities and toward the securities issued in Europe by U.S. corporations to finance direct investment abroad. As foreigners ponder the upward trends of U.S. prices and U.S. imports, their recently lukewarm appraisal of dollar securities could grow still cooler. The projection we are using makes no allowance for this possibility and instead calls for a considerable increase in foreign purchases.

The over-all balance of payments deficit over the next 12 months could be very large. A guess of $6 billion for the deficit on current account and long-term capital allows for high imports, but assumes a large inflow of foreign long-term capital. Other elements in our projection also represent compromises between pessimism and optimism. A zero balance on "short-term nonliquid capital" assumes that bank credit outflows permitted by the voluntary foreign credit restraint program will be offset by net inflows in corporate accounts. We assume negative errors and omissions of $1 billion, which would be a normal average for that item. The projection assumes, in effect, no net inflow or outflow of short-term capital, including liquid funds sensitive to interest rates and exchange rate prospects. A deficit on the new "net liquidity" basis of the order of magnitude of $7 billion is well within the range of possibilities. The official settlements deficit would be somewhat smaller if, and while, U.S. banks were again expanding their borrowings of Euro-dollars; but it might be as large as the "net liquidity" deficit if, for example, increases in head office liabilities to branches were offset by redemptions of Export-Import Bank and Treasury special securities.

Mr. Partee concluded the presentation with the following comments:

The outlook for the domestic economy, as described, is one of gradual, rather than robust, cyclical recovery. This seems to us far and away the most probable course of events, even though recent information--as reflected in the data for new orders, insured unemployment, and retail sales, for example--is disturbingly suggestive of an interruption in the trend of recovery. We would judge any such hesitation to be temporary, albeit reflective of the tenuous character of the upward movement thus far.

A continuing economic improvement equal to the course we have charted, however, would produce results not very satisfactory to anyone. Dollar GNP growth is likely to be substantial, but much of the gain will probably continue to reflect higher prices, with real growth proceeding at rates not very much faster than expansion in our growth potential. If so, unemployment rates are likely to remain unacceptably high and factory utilization rates historically quite low throughout the projection period.

Despite continued substantial slack in the economy, we believe that the rate of inflation is likely to remain at unsatisfactorily high levels. This will be due mainly to persisting rapid rates of increase in employee compensation in the face of only moderate productivity gains. However, business efforts to capture something for profits as dollar volume rises also will be a contributing factor. Meanwhile, the balance of payments outlook--and particularly the prospects for net foreign trade--remains quite unfavorable, in spite of the comparatively low rates of output and demand projected for the domestic economy.

The situation as we see it clearly makes for very hard choices in the area of public economic policy. The indicia of appropriate policy responses--resource utilization, real economic expansion, price performance, and international competitiveness--obviously are behaving in quite unsatisfactory ways, and we see little improvement through the projection period. For monetary policy the questions seem even harder, since the intermediate targets of policy--growth in the monetary aggregates and interest rate levels--are also giving conflicting signals. Recent expansion in the money supply has been too rapid for almost anyone to view with equanimity, and yet rising interest rates, given their current high levels, seem most inappropriate to the current and prospective condition of the economy.

We believe that monetary policy has done about all that it should to stimulate economic recovery. But we would recommend toleration of the current high monetary growth rates for a while longer in the expectation that such growth will moderate in the fall, and in the hopes of avoiding another upward ratcheting in interest rates. Meanwhile, faster expansion in the economy, we believe, can best be encouraged through a temporary liberalization of fiscal policy. In view of the substantial shortfall we expect in real economic performance, it will take a sizable dose of fiscal stimulus to achieve meaningful results.

We have considered the effects on Federal expenditures and revenues for fiscal 1972 of a program designed to give a significant, but short-lived, boost to economic activity. The program calls for a speedup to this June 30th in the tax reforms already legislated. It also incorporates a temporary reduction, for fiscal

1972 only, of 10 per cent in the individual income tax. These actions would cut about $12-1/2 billion from indicated Federal receipts for the fiscal year, but with the higher income generated by faster economic expansion, about one-third of that revenue loss would be recaptured within the same year. After fiscal 1972, of course, Federal revenues would be increased substantially by the termination of the negative surtax as well as by the enlarged flow of private sector incomes that persists.

Using these more stimulative fiscal assumptions, we have attempted to judge what the economic effects would be, extending the projections through the end of 1972, with the help of our econometric model. To insure that the full benefits of this fiscal stimulus would carry through, we have assumed a one-percentage-point larger growth in money supply after the third quarter than in our standard projection. This would hold down the rise in money velocity and avoid a constriction in private financial markets that would partially offset the expansive effects of larger Federal deficit financing.

The stimulus from the reduction in Federal tax rates would show up immediately in the GNP figures, since personal disposable incomes would be boosted by lower withholdings, and some of the increase flows through quickly to consumption. Moreover, the effect would still be quite discernible beyond the end of fiscal 1972 because the rise in consumption generates additional income and stimulates other expenditures, including especially business spending on inventories and capital investment. By the end of next year, the projection indicates that nominal GNP would be running some $26 billion higher than without this extra stimulus, and that the rate of real output would have been increased by slightly over 2 percentage points. Much of the effect of higher output is transmitted to an improvement in the employment picture, with unemployment dropping by 1.2 points to 5.3 per cent in the fourth quarter of 1972, rather than by only 0.3 points in the standard projection. But prices also rise somewhat more in the stimulative alternative, reflecting both a slightly faster increase in employee compensation and better profit margins; the private fixed-weight deflator is projected to slow very little and to be rising at nearly a 4-1/2 per cent rate in the latter part of 1972. These estimates, of course, have to be read with the usual degree of uncertainty surrounding an assessment of any major shift in public policy, but we believe them to be reasonable.

The trade-offs in policy judgment are highlighted sharply in the two alternative projections. The standard projection shows unemployment remaining disturbingly high throughout 1972 and real output--though accelerating--growing at a relatively moderate rate. The stimulative alternative improves on this physical outcome considerably, but at the cost of a substantially larger deficit for fiscal 1972 and an even weaker performance in dampening the pace of inflation. Demand pressures, however, would not be an important cause of inflation even in the stimulative model. The gap between projected and potential output is significantly narrowed in the higher growth model, but at year-end 1972 it still amounts to 4.7 per cent.

The question of whether or not there needs to be additional fiscal stimulus is essentially one for the Administration and the Congress to decide. For the time being, the Committee must determine its policy in the absence of any fiscal action known to be in prospect. The Committee could seek to reestablish its 6 per cent growth target in money, but we think this would be a mistake for the reasons given by Mr. Gramley. To check this we have run the econometric model on a 6 per cent money assumption; it shows significantly lower growth in real GNP and an unemployment rate approaching 7 per cent by the latter part of 1972, with very little additional benefit in terms of a lower inflation rate.

I believe that the Committee should accept the 9 per cent growth in M_1 now projected for the third quarter, while seeking to establish longer-run growth at about 7 per cent. That would be consistent with relatively little increase in money velocity over the projection period, and should make possible a continuation of interest rates that on balance are near current levels.. Draft alternative B[1/] seems to me to accord with this policy prescription, provided that the Committee is alert to the need to relax

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

money market conditions later on if monetary growth should begin to fall significantly short of the 7 per cent path specified for M_1.

Chairman Burns recalled that he had not given a very optimistic response at the previous Committee meeting to a question by Mr. Heflin regarding the prospects for Administration action on an incomes policy. Decisions in that area and with respect to fiscal policy had been announced this morning; a report just received on the news ticker read in part as follows: "The White House said today President Nixon will not seek tax reductions to give the economy further stimulation, nor will he attempt to speed up Federal spending. In addition, the White House announced Nixon will veto a $5.6 billion public works bill, including a proposal to create jobs for the unemployed. Secretary of the Treasury John B. Connally told newsmen Nixon will not institute a wage and price review board in an attempt to control inflation, nor will he use powers granted to him by Congress to clamp down mandatory wage and price controls on the economy."

The Chairman then suggested that the Committee move on to a discussion of the economic situation and outlook. He added that the staff deserved the Committee's gratitude for today's presentation, which he had found to be extraordinarily effective.

Mr. Maisel observed that the economy described in the staff presentation was one in which actual output grew at about the same rate as potential output and unemployment remained more or less steady. It seemed to him that a fair proportion of Committee members--not including himself--thought that it should be the goal of policy to reduce the rate of increase in the GNP price deflator to about 3 per cent and to cut the deficit in the balance of payments to about $3 billion, no matter what the effect on output and employment. In his judgment the staff had not served the interests of those members when it failed to present an alternative projection indicating the kind of monetary policy that might be required to cut the advance in the deflator to a 3 per cent rate by, say, the end of the fiscal year, and showing the resultant impact on output and employment.

Mr. Partee said the staff might have sought to answer that question by using its econometric model. However, he would have great doubts about the dependability of the results, because a new force had emerged that was not fully taken into account in the model--namely, the strong upward pressure on employee compensation, relative to that at the same stage of past cycles. It was his guess that even without allowance for that force the model would indicate that a slowing of the rise in the deflator to 3 per cent within a year would involve a very sharp cut in the growth rate of the money supply and a large increase in unemployment. In his judgment it would be almost impossible to achieve such a slowing in the absence of a new incomes policy, given present fiscal and structural problems, without unacceptable effects on unemployment. The slowing of growth in the private deflator shown in the projection--to 4 per cent by mid-1972--seemed to be about as much as could be hoped for, if one assumed that an unemployment rate substantially higher than the present rate could not be tolerated. In short, the staff believed that existing constraints left the Committee with a rather narrow range of policy choices.

Mr. Brimmer noted that in its alternative projection the staff had assumed some substantial stimulative actions through fiscal policy. However, the news story the Chairman had just read would seem to rule out such fiscal actions. He asked whether the staff had had any grounds for expecting such an announcement.

Mr. Partee responded that, while the staff usually had some advance indications of the thinking of the Administration, there had been absolutely none in this instance. The secret had been well kept.

Chairman Burns observed he did not think it was a matter of secrecy; more likely, the President had not made his decision until shortly before the announcement.

Mr. Partee remarked that he had two comments regarding the announcement. First, it should not necessarily be assumed that the President would hold to the position described for the indefinite future.

The Chairman agreed, adding that it was also possible that Congress might not go along with the policy announced today.

Mr. Partee said his second comment was that he personally would not recommend to the Committee that it introduce the degree of monetary stimulation that would be needed to make up for the absence of additional fiscal stimulus. The rate of monetary expansion was already quite high, even after adjustment for price increases, and he would expect that a still higher rate of money growth could have particularly injurious effects on the economy over the longer run.

In reply to a question by Mr. Mitchell, Mr. Partee said that the events of the past six years or so seemed to indicate that a substantial change in the rate of growth of the money supply engendered forces that had long-lasting effects.

Mr. Mitchell then noted that in an earlier period--say, fifteen years ago--relatively little attention had been paid to the growth rate of the money supply in formulating monetary policy. He asked Mr. Partee whether--thinking in the framework of that period and ignoring the money supply--one could offer any evidence that monetary policy could not now be eased from its present stance.

Mr. Partee replied that one could argue that the prevailing economic situation and outlook called for lower interest rates. Indeed, that argument had been advanced recently by some of the Board's academic consultants. In his view it was not an unreasonable position; interest rates certainly were quite high, even after allowing for an inflationary premium. The difficulty, however, was that to reduce interest rates it would be necessary to step up the growth rate of the monetary aggregates substantially. As he had indicated, he would not recommend such a course because of the risk that destabilizing forces would be set in motion over a longer period of time.

Chairman Burns remarked that anyone arguing that faster expansion of the monetary aggregates always tended to reduce interest rates might have difficulty explaining developments in the period since March, when very rapid expansion in M_1 had been accompanied by sharp interest rate increases. It appeared that high growth rates in the aggregates could stimulate inflationary expectations which could lead to higher rather than lower interest rates.

Mr. Mitchell noted that Mr. Partee had referred to the money supply in answering his (Mr. Mitchell's) question. He asked how Mr. Partee thought a staff adviser to the Committee of the mid-1950's might have responded.

Mr. Partee replied that in the period to which Mr. Mitchell referred the money supply was tending to increase at relatively low rates. Money supply statistics were available then as now, however, and he had little doubt that advisers of that day would have been concerned if those figures indicated growth for an extended period at rates of 10 per cent or more, such as had been recorded recently.

Mr. Mitchell observed that it had been possible for the money supply to grow slowly in the earlier period because the turnover of money had been rising at a substantial rate. That situation no longer prevailed. However, at some point in the future turnover was likely to start rising rapidly again, as the System implemented the various elements of the recently announced program to improve the payments mechanism. At that time it would once more become possible to accommodate a given increase in GNP with a much smaller increase in money.

Mr. Gramley said he thought there were many signs other than the high rate of money growth to indicate that the stance of monetary policy had been expansive for some time. One was the substantial improvement that had occurred in the liquidity position of banks over the past year. Another was the very heavy volume of savings inflows to nonbank thrift institutions through May. A third was the recent expansion of residential construction expenditures and State and local Government outlays. All of those developments were consistent with the classic pattern of response to monetary stimulus, and accordingly they tended to confirm the interpretation one would place on the recent behavior of the money supply. It was not the case that the money supply figures suggested ease and other evidence indicated restraint; the bulk of the evidence pointed in one direction.

Although he was not a monetarist, Mr. Gramley continued, he thought the Committee could not disregard the monetary aggregates. Monetary policy worked with long and variable lags; in a situation like the present, when the need was for a sharp, temporary stimulus, the appropriate source of that stimulus was in the fiscal area. That, he thought, was the essence of the staff's message today.

Mr. Mitchell commented that while he did not necessarily disagree with the staff's advice, he would note that it created a dilemma for the Committee, given the present posture of the Administration with respect to fiscal policy. The staff was suggesting that the Committee should pull back from the recent rate of growth in M_1 and do nothing further for a considerable period of time.

Mr. Mayo noted that in its stimulative alternative the staff had assumed not only an easier stance for fiscal policy but also a somewhat faster rate of growth in M_1. He would have found it helpful in visualizing the consequences of the assumed fiscal stimulus if the same M_1 growth rate had been used as in the standard projection. He asked whether the additional money supply growth made a significant contribution to the higher rate of increase in GNP in the alternative projection.

Mr. Partee replied that the difference in M_1 growth rates in the two projections was of marginal importance. A higher growth rate had been assumed in the stimulative alternative in order to keep velocity from rising considerably faster; or, to put in another way, to reduce the extent to which the increase in demand for credit by the Federal Government was offset by a reduction in supplies of credit to the private sector. If the higher monetary growth had not been assumed, he would estimate roughly that about one-quarter of the added stimulus provided in the alternative model would have been lost.

Mr. Morris said he had some evidence which tended to confirm the staff's expectation of a slowdown in the rate of growth of deposits at nonbank thrift institutions in the last half of the year. Data for mutual savings banks in New England indicated that the process had already begun. For New England as a whole, net inflows to mutual savings banks averaged $123 million per month during the first five months of 1971, but they were estimated to have been only $37 million during the first three weeks of June. For Boston alone the figures were $33 million for the first five months and $4 million thus far in June. At a meeting at his Bank yesterday afternoon officials of the six largest mutual savings banks in Boston had pointed out that earlier in the year, when there had been sharp declines in short-term money rates, they had received substantial inflows in the form of very large deposits by sophisticated investors seeking a short-run haven for their funds. Such deposits were now flowing out for investment in corporate bonds and other securities on which returns competitive with the rates offered by the mutuals were available. The Boston savings banks were being hit much harder than those elsewhere in New England, presumably because their depositors included a higher proportion of sophisticated investors.

In reply to a question by Chairman Burns, Mr. Morris said that data were not yet available on the First District unemployment in June. In general, unemployment in the District tended to parallel that in the nation as a whole, although the rate in Massachusetts alone usually was somewhat below the national rate.

Mr. Morris then remarked that one question the Committee should keep in mind concerned the level of money market rates--the Federal funds and Treasury bill rates--that would affect flows to thrift institutions in such a manner as to constitute a threat to the recovery in housing. He asked Mr. Gramley for his view on that question.

Mr. Gramley replied that in his judgment there was no single trigger point at which funds could be expected to flow out of thrift institutions in massive volume; rather, there was a continuum under which higher market interest rates would lead to reduced net inflows. The staff's expectation of a sharp drop-off in net inflows during the second half of 1971 was based on a presumption that there was a lag in the adjustments by individual investors to changes in relative yields, reflecting the fact that investors frequently held the assets they acquired until maturity and only then considered the question of whether to change their form. The staff no doubt would want to reassess its projections of flows to savings institutions, to the mortgage market, and so forth, if bill rates were expected to be considerably higher than assumed. However, he was not prepared to specify any particular rate level as critical.

Mr. Partee added that the projections of flows to thrift institutions in the second half of the year were based on an assumption that the three-month Treasury bill rate would be in a 5-1/4 to 5-1/2 per cent range. The analysis of prospective flows of funds suggested that the situation in the mortgage market would remain fairly comfortable at that bill rate level, partly because a considerable increase in Federal lending to the market appeared to be in prospect for the coming fiscal year.

Mr. Hayes reported that data for the sixteen largest mutual savings banks in New York City indicated a net deposit inflow of $71 million during the first half of June. That was about the same as in the corresponding period of 1967. It was difficult to convert the figure into an estimate for the full month of June because of seasonal adjustment problems. It appeared, however, that while inflows were slowing they nevertheless were still substantial.

Mr. Daane referred to Mr. Mitchell's earlier comment that in the mid-1950's the Committee had paid relatively little attention to the money supply. He thought that view was substantially correct, even though staff members had commented on the monetary aggregates in that period and at least one Reserve Bank President had repeatedly urged the Committee to give greater weight to the aggregates. As the members knew, he (Mr. Daane) had been concerned for some time that the Committee was now placing too much emphasis on the aggregates in its directives to the Manager, and by that process had led the market and the public generally to pay them undue attention. He wondered if there was any method by which the Committee could deemphasize the aggregates at this juncture, so that it could provide somewhat more stimulation to the economy without creating a resurgence of inflationary expectations.

The Chairman observed that he was not aware of any means by which the Committee could provide significantly greater stimulus to the economy except that of supplying reserves at a faster rate.

Mr. Gramley remarked that in his judgment the effect of monetary policy on the economy did not depend in any basic sense on whether the Committee formulated its instructions for operations in periods between meetings in terms of conditions in the money market or of growth rates in the monetary aggregates. The question to which today's staff presentation had been addressed was a much more fundamental one. At present the economy was very soggy, even though the System had been providing a great deal of monetary stimulus--as evidenced by data on the real money supply, real interest rates, bank liquidity, flows to thrift institutions, and so forth--and the question at issue was whether the System should supply still more stimulus. If he were completely certain that the staff's projection was an accurate forecast of economic developments, he would recommend an affirmative answer to that question. But such certainty was not possible. Accordingly, it seemed proper to employ a form of stimulus that could be withdrawn quickly. The essence of monetary policy was that it worked over a long period of time with lags of uncertain length. In his judgment there was nothing the Committee could do with respect to the form of its instructions that would resolve that problem.

Mr. Daane said he also thought that the Committee should concern itself with fundamentals. He doubted, however, that the staff had helped the Committee to do so when it formulated alternative choices for policy in terms of the levels of the Federal funds rate that would lead to third-quarter growth rates for M_1 distinguished by differences of 1 percentage point, as in the current blue book.[1/] The focus on the aggregates posed a problem for the Committee whatever its decision with respect to additional stimulus, since many observers were of the view that the current growth rates of the aggregates were inflationary.

Mr. Partee said he would agree that the amount of attention given to the monetary aggregates by outside observers posed a problem in terms of expectations. He did not know of any solution to that problem, since the market was simply responding to a particular theory of the monetary policy process--a theory which, incidentally, had had a relatively good forecasting record over the past few years. If that theory was wrong--and he was not sure it was--the market could be weaned from it only by a long educational process or by a clear demonstration of failure. The Committee's directive was, after all, only an instrument for giving the Manager instructions. It seemed to him that the Committee had to have some means of communicating with the Manager in terms of specific guides, and if one ruled out the Federal

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

funds rate and the money supply it was not clear what variables it would use.

Mr. Daane commented that the Committee's instructions could be formulated in terms of approximate benchmarks for bank reserves, availability of credit, interest rates, and money market conditions.

In response to the question of whether the System could take any stimulative actions that did not depend on increasing the growth rate of the money supply, Mr. Partee remarked that there were various structural changes the System might make, such as revising Regulation Q and emphasizing coupon issues in open market operations. Such actions could have some marginal effects on developments with respect to interest rates and credit availability. Personally, he would not be wedded to any particular growth rate for M_1 if it appeared that conditions in financial markets would not be conducive to credit flows reasonably well matched with credit demands under that growth rate. Certainly, he would like to see some decline in interest rates, and he did not fully understand what was holding rates up. In any case, the staff's analysis suggested that during the coming twelve months the markets would clear rather well with the M_1 growth rates assumed. The problem was that economic activity was unusually weak relative to the level of demands for credit in the private sector, presumably reflecting a widespread desire to rebuild liquidity and improve debt structures. That problem was a difficult one for monetary policy to deal with.

Mr. Francis said that, by way of background to the current business situation, he would like to report on a luncheon meeting held at the St. Louis Reserve Bank this past week during which twelve top executives of major businesses in St. Louis were asked to comment on the present state of the economy and the outlook for their particular firm and industry, on their assessment of the prospects for inflation, and on the outlook for short- and long-term interest rates.

To a man, Mr. Francis observed, the participants reported that their business had been strengthening rapidly in recent months; and they all expected a continuation of growth of sales through the balance of this year. To some, that strengthening of sales indicated improved corporate profits, although none were predicting records. Others voiced strong concern that costs of production, especially labor costs, were likely to keep pace with growth in revenues, and they indicated that they were mainly hopeful of maintaining narrow profit margins in the foreseeable future. In retail trade, the indications were that significant growth in dollar volume was necessary just to maintain constant unit sales.

On the subject of over-all inflation, Mr. Francis continued, there was not a single member of the group who believed there would be any further reduction in the rate of inflation. There was much discussion about the role of rapid growth of Government spending, especially at the Federal level, in portending a high rate of inflation well into this decade. There was strong approval for assertions that worldwide inflation should be accepted as a fact of life, and that anyone who held out hope that stabilization authorities in Washington had any real desire to do something about reducing inflation in the United States was being very naive.

That position on inflation was almost a complete reversal of the position of leading St. Louis businessmen a year ago, Mr. Francis said. Last year they were concerned about real economic growth and about Government response to rising unemployment. But at that time they saw inflation working its way down over the years ahead. At the meeting last week there was not a single voice of concern for the level of unemployment.

Mr. Francis reported that those businessmen who commented on the outlook for interest rates did so very briefly. They simply said "higher." None were willing to be specific as to how fast or how far either short- or long-term interest rates might rise, but they said their plans for the future were based on higher interest rates.

Mr. Heflin said he had a question in connection with the news announcement the Chairman had read earlier. It was possible, he thought, that the Administration's view of the economic outlook differed from that set forth by the Board's staff today. He wondered, for example, whether the Council of Economic Advisers was still expecting GNP to reach a level of $1,065 billion in 1971.

Chairman Burns said it was his understanding that the Council's thinking was running along basically the same lines as that of the Board's staff.

Mr. Partee observed that that was his impression also.

Mr. Swan remarked that he might add a note to the earlier comments regarding flows to nonbank thrift institutions. A recent check with major savings and loan associations in California revealed that they had received fairly strong inflows during the first ten days of June. Although there had been some moderation in the next ten days, it appeared likely that flows in all of June would set a record for the month.

Mr. Swan added that housing starts in California had, of course, been very strong so far this year. However, the marked slowing of population growth in the State was beginning to raise some questions about the dangers of over-building, and about the level of starts that would be attained next year.

Mr. Coldwell commented that as he listened to the discussion this morning his thinking reflected more in the way of policy frustration than anything else. To him the conditions the staff had outlined in their presentation were highly unsatisfactory. Unemployment was too high and the outlook was for further increases; inflation was proceeding at too rapid a rate; short-term interest rates were too low for international reasons, but long-term rates were too high for domestic growth. Expectations for prices were deteriorating and budget deficits and planned spending constituted a major stimulant--although the President apparently had now taken the position that there should be no further fiscal stimulation at the moment.

Mr. Coldwell remarked that the prospect for slow improvement in the economy, with rising prices and rising unemployment, should be unacceptable to the Committee and to the nation. The question was what could be done by monetary policy or other types of stabilization policy. He considered it likely that growing dissatisfaction with high-level stagnation would force policy changes.

Mr. Coldwell then noted that he had been particularly interested in Mr. Gramley's comments on the question of why the recent rapid growth in the money supply had not fostered a marked improvement in economic activity. He gathered that the staff's explanation ran in terms of a lag in the buildup of inventories. That struck him as not likely to be the full explanation, in view of the high rate of money supply growth so far this year and over the past twelve months.

Mr. Gramley said he certainly had not meant to suggest that the behavior of inventories was the only factor involved. The point he had intended to make was that private sector demands in general appeared to be quite weak. He had highlighted inventories because in past recoveries a turnaround in inventory investment characteristically had been the trigger to the cumulative accelerator-multiplier process, leading to increases in growth of consumer spending which in turn stimulated business capital spending. During the first four quarters of the past three recoveries a shift from declining to rising rates of inventory investment had accounted for anywhere from about one-fifth to about one-third of the total increase in GNP. That stimulus was likely to be absent in the present recovery.

In response to a question by the Chairman, Mr. Gramley said there were two main reasons for not expecting the customary stimulus from inventories. First, the usual disinvestment had not occurred in the recession phase of the present cycle, so there was less room for a turnaround. Secondly, final sales were not expanding at a rate high enough to generate the business optimism necessary to lead to large-scale efforts to expand inventories.

Mr. Coldwell asked why final sales had not grown more in response to the recent improvement in the liquidity of the economy.

Chairman Burns remarked that if his recollection was correct there were only two instances in the record--which went back to 1870--of the nation's economic history in which an economic recovery had not been led by an increase in new orders or contracts for business fixed capital. The first was the recovery of 1914, which had been stimulated by a rise in exports related to the outbreak of World War I; the second was the recovery of 1933, which had been led by the consumer sector. In the present economic expansion business fixed investment was declining in real terms and clearly was not playing its traditional role in the recovery process. He thought the fundamental reason was that businessmen, in thinking about the future, saw their costs rising sharply because of wage-push. They anticipated that they would be able to raise their prices, but perhaps not by as much as their costs went up. Accordingly, they thought profit margins, which now were at almost their lowest point since World War II, might not recover very much. Under those conditions businessmen hesitated to make new capital investments. The return of confidence, which normally had been instrumental in generating a faster recovery, was just not occurring at present.

In reply to questions by Messrs. Mitchell and Coldwell, the Chairman said he had been speaking of investment in plant and equipment, excluding inventories. He agreed with Mr. Gramley's observations regarding inventories and considered his own comments to be a supplement which strengthened the point the latter had made.

Mr. Mitchell asked whether the current behavior of businessmen might not be explained in part by the fact that the long capital boom had led to the accumulation of a large stock of plant and equipment.

The Chairman commented that ordinarily in past business cycles new investment orders for plant and equipment had picked up at a time when sales and employment were still weak and unused industrial capacity was still rising. That phenomenon was, of course, partly due to the fact that there was a considerable lag in the installation of new plant and equipment, and that businessmen were ordering in advance of deliveries in the expectation of increasing sales.

Mr. Hayes said he thought that, on the whole, the staff's presentation today had been excellent. He would note only one or two points at which the New York Bank's analysis led to slightly different conclusions. His staff was a little less pessimistic about the inventory outlook than the Board's staff; they felt that the behavior of over-all sales-inventory ratios offered somewhat greater hope of a step-up in that area. Secondly, in light of the general concern about the present level of long-term interest rates, his staff had made a rather careful sector-by-sector analysis of the availability of funds. Their conclusion was that funds were likely to be available in rather generous volume. It appeared, consequently, that fears that the recent rise in long-term rates might abort the recovery probably were exaggerated.

Mr. Brimmer said he would add a comment on a question raised earlier about the relationship between recent growth rates in the money supply and the behavior of interest rates. It was his impression that liquidity preference was increasing at a pace more than sufficient to offset the stepped-up rate of growth in the money supply. If that situation persisted, interest rates were likely to remain high and perhaps rise further.

Mr. Brimmer then asked Mr. Holmes how the market was likely to react to today's statement by the Administration.

Mr. Holmes replied that while it was always dangerous to predict how the market would react to some particular development, he thought this morning's announcement would be interpreted as a "do-nothing" policy and would be discouraging to a market that was looking for leadership. The corporate market might be relatively immune to bad news for a while, but that was not necessarily true of the other markets.

Chairman Burns said he might take this opportunity to read another news item that had come over the ticker. "President Nixon today vetoed a $5.6 billion public works bill, saying it 'would not even make a real start on delivering on its implied promise' of quickly creating new jobs.... While vetoing this bill, the President asked Congress to promptly enact an Administration-backed Emergency Employment Act which would finance the creation of temporary public service jobs which, Nixon argued, could be rapidly filled without the delays inherent in public works projects. The measure he favors has cleared a Senate-House Conference Committee."

In reply to a question by the Chairman, Mr. Partee said the staff's projection had taken into account the probability of such legislation to create public service jobs.

Chairman Burns then suggested that the Committee move on to a discussion of open market operations.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period June 8 through 23, 1971, and a supplemental report covering the period June 24 through 28, 1971. Copies of both reports have been placed in the files of the Committee.

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

> System open market operations over the three-week period since the Committee last met were designed to provide reserves reluctantly in light of the continued rapid expansion of the monetary aggregates. As a result, money market conditions became progressively firmer, banks were forced into greater use of the discount window to meet reserve requirements, and interest rates again increased on balance.
>
> The capital markets were quite weak early in the period, with market participants apprehensive about the Treasury's cash needs at a time when it had become apparent that the Federal Reserve was fostering firmer money market conditions to combat an excessively large increase in the money supply. A somewhat better atmosphere emerged after a good market reception of the Treasury's cash financing package announced on June 16 and an apparent slowdown in the calendar of new corporate issues. The municipal market remained depressed throughout the period, and an air of uncertainty--in part related to the large increase in consumer prices in May and the jump in money supply reported last week--continued to pervade the capital markets as the period came to an end. The markets took some encouragement from the fact that the major money market banks did not join in the prime rate increases announced by a handful of smaller banks, but participants generally feel that an eventual move to a 6 per cent rate is only a matter of time in light of the general increase in market rates.
>
> Short-term rates--on Treasury bills, certificates of deposit, bankers' acceptances, and commercial paper--also rose over the period. In yesterday's regular

Treasury bill auction average rates of 5.08 and 5.28 per cent were established on three- and six-month bills, respectively, each up about 57 basis points from rates established in the auction three weeks ago. The auction was quite weak, with an exceptionally long tail on both bills. As the supplementary report to the Committee indicates, we had intended to let $150 million of maturing bills run off in yesterday's auction in order to be in a better position to accommodate heavy foreign bill sales. Given the weak auction, however, our tenders--priced 10 basis points above the expected average rate--were accepted by the Treasury. This morning the market rate on three-month bills was 5.20 per cent, about 25 basis points above yesterday's close.

The Treasury's cash offer of $2-1/4 billion of 16-1/2 month notes at auction went quite smoothly with an absolute minimum of even keel consideration. And its auction tomorrow of $1-3/4 billion of September tax bills should not cause any particular problems, although with the weakness that has developed in the bill market one can never be altogether sure.

System open market operations over the period, however, had to take account of a huge swing in the Treasury's cash position and a special German investment program--announced by the Treasury yesterday--that will involve a massive liquidation of Treasury bills. As you know, the Treasury ran out of cash just prior to the June tax date and had to borrow directly from the Federal Reserve Banks from June 8 to 16--in the process supplying a massive amount of reserves to the market which open market operations had to mop up. Peak borrowing of $610 million was less than had been anticipated, mainly because in raising cash to meet sales of dollars in the exchange market the German Federal Bank switched from liquidating special certificates, which involves a direct cash drain on the Treasury, to the sale of Treasury bills, which does not. As a result, we did not need the special $2 billion leeway for direct lending that the Committee authorized at the last meeting. With the Treasury having restored its cash position, I recommend that the leeway again revert to the customary $1 billion amount.

The long-pending German decision to invest $5 billion in one-to-five year special Treasury securities should have an encouraging effect on foreign exchange markets, and it seemed important to facilitate an early completion of the operation through as much help from open market operations as would be consistent with our broader reserve objectives. The first tranche of the operation--the switching of $3 billion into longer-term securities--was completed on Friday, as Mr. Coombs noted earlier. It involved the conversion by the Germans of $2 billion short-term special certificates and the sale of $1 billion Treasury bills. Given the large need for the System to supply reserves last week and in the next two weeks, we acquired $700 million of these bills directly from the Germans, with the Treasury agreeing to run its balance with the Federal Reserve banks higher than usual on a temporary basis, to avoid any oversupply of reserves.

Since it would appear desirable to complete the full $5 billion operation as soon as possible, the Germans will be heavy sellers of Treasury bills in the weeks ahead--up to $2 billion, a portion of which will probably be bought by the System Open Market Account. The operation could have a depressing effect on the Treasury bill market as the market's perception of it increases. On the other hand, the Treasury will have raised up to $3 billion in new cash, thereby significantly reducing its need to raise money in the market by mid-August and thereby lessening the pressure on the market in the weeks ahead.

The behavior of the monetary and credit aggregates has been amply discussed in the written reports to the Committee, and I have little to add. The evidently very strong performance of M_1 continues to be hard to understand, given the continued sluggish ecoromy and the moderate expansion in bank credit. I suppose we can only hope that the apparent shortfall from path in the latest statement week is a harbinger of better things to come. For whether the rapid growth of M_1 means anything or not, there can be little doubt that it has become a major issue not only for the more academic critics of the System but also in the financial markets themselves.

Mr. Daane asked whether the Manager could suggest any operational measures that would encourage a decline in long-term interest rates.

Mr. Holmes replied that in his judgment there was very little the Desk could do in that regard. On Friday the Account Management had purchased a moderate amount of Government coupon obligations in the market, but he thought it would be inadvisable to push such operations very far under current circumstances. Short of a substantial downward revision in recent M_1 figures, the main source of hope lay in the recent behavior of the corporate bond market, where a lightening of the forward calendar apparently was resulting in a significant reduction of interest rate pressures. A similar relaxation of pressures had not been evident in either the Treasury or municipal bond markets.

Mr. Melnicoff noted that the differences between the projections of M_1 by the staffs of the Board and New York Bank were wider than usual. He asked whether an attempt had been made to reconcile the projections.

Mr. Holmes replied that the staffs had been looking into those differences recently. They had cited a number of technical factors at work but in his judgment, at least, they had not yet produced a satisfactory explanation.

Chairman Burns remarked that it would be helpful to the Committee if Mr. Holmes would briefly compare the two sets of figures for the months ahead.

Mr. Holmes said that, on the assumption that prevailing money market conditions would be maintained, the Board's staff projected that M_1 would rise at annual rates of 10.0, 10.0, and 8.5 per cent, respectively, in July, August, and September; the New York Bank projections for those three months were 5.5, 12.0, and 3.0 per cent. Over the third quarter as a whole the projected increases were 9.5 per cent at the Board and 7.0 per cent at the New York Bank. It was perhaps worth noting that the difference in the figures for the third quarter was smaller than in the projections of just a week ago, when the New York Bank had been projecting a growth rate of 5.0 per cent.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 8 through 28, 1971, were approved, ratified, and confirmed.

By unanimous vote, the dollar limit specified in paragraph 2 of the continuing authority directive, on Federal Reserve Bank holdings of short-term certificates of indebtedness purchased directly from the Treasury, was decreased from $2 billion to $1 billion. As amended, paragraph 2 read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, or, if the New York Reserve Bank is closed, any other Federal Reserve Bank, to purchase directly from the Treasury for its own account (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate 1/4 of 1 per cent below the discount rate of the Federal

Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed $1 billion.

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

Given the Committee's decision at the last meeting to seek a slowing of growth in the monetary aggregates, several logical questions merit consideration today. First, to what extent can further deceleration in growth of the aggregates be expected over the months ahead even if no further tightening of money market conditions occurs? Secondly, if a more rapid slowing of money supply growth is desired than would seem likely with no further policy action, how much firming in money market conditions may be needed to achieve an appreciably greater slowing over the near term? Finally, if money market conditions are tightened further, how large a response can be expected in other interest rates? The three blue book policy alternatives were selected with a view to highlighting the likely answers to these questions.

Under all three of the alternatives, growth paths projected for the narrowly defined money supply show only a relatively modest further slowing during the third quarter. However, it should be noted that there has already been an appreciable slowing thus far in June. On a week-to-week basis M_1 has shown some tendency to level off relative to its end-of-May level, and for several weeks revisions have all been on the downside. The main reason M_1 is expected to continue growing fairly rapidly in the third quarter is the strong demand for transactions balances being generated at current interest rates by the projected increase in nominal GNP. In addition, two temporary influences are expected to add to money balances in July. One of these is the corporate repatriation of funds to meet end-of-quarter requirements of the Office of Foreign Direct Investment. The other is the large retroactive payment of social security benefits that has just been made.

Looking beyond the third quarter, however, staff analysis suggests that the slowing of M_1 growth which is evident in the blue book projection for September will probably extend significantly further. This judgment is based essentially on historical evidence of lagged responses in money balances to marked interest rate changes. As the incentive to add to demand deposits generated by the earlier steep interest rate declines finally peters out, the impact of the large interest rate increases that have occurred since March should begin to show through more strongly in slower demand deposit growth.

A plausible hypothesis has been advanced that some of the rapid second-quarter growth in M_1 has reflected temporary demands for precautionary balances. As Mr. Gramley has noted, there is some empirical confirmation of this possibility. A number of considerations could have generated such demands--for example, uncertainties about job lay-offs and employment prospects, worries about impending adjustments in international exchange rates, concern about possible sudden sharp increases in interest rates, and uncertainties about the stock market. To the extent forces creating demands for precautionary balances subsequently disappear, the rate of growth of money balances will, of course, be slowed. Some allowance has been made for this possibility in the blue book projections, but if such a development should prove to be more significant than we now expect, money supply growth might slow more than projected, even in the third quarter.

In regard to the blue book projections of other money and credit aggregates, the principal point to note is that under all three policy alternatives growth of the adjusted credit proxy in the third quarter would be more rapid than in the second, and it would slightly exceed third-quarter growth for both M_1 and M_2. This contrasting behavior of the proxy reflects a large projected rise in U.S. Government deposits and a leveling off of the second-quarter decline in non-deposit sources of funds.

Turning back now to the questions that I posed earlier, while there appears to be a fairly good chance of some further deceleration of growth in the monetary aggregates by September and during the fourth quarter even if there is no further firming of money market conditions, alternative B of the directive drafts would seem to provide near-term growth paths for the aggregates most nearly consistent with the assumptions of today's staff presentation. If alternative B were adopted, there might be some risk that further money market firming, in combination with the lagged effects of earlier interest rate increases, would produce a more pronounced fourth-quarter slowing of M_1 than desired. The chances of such a shortfall would be much more likely, however, under alternative C. If a fourth-quarter shortfall below target did begin to develop, the course of money market rates would probably have to be reversed at least temporarily, and even so it might take a while to get money supply growth back on track.

The substantially greater vulnerability of alternative C to an undesired fourth-quarter shortfall in the growth of M_1 is, of course, attributable to the rather substantial immediate repercussions it would very likely have on other interest rates. In the case of alternative B, acceptance of the indicated money market specifications would represent a much less drastic move, since Federal funds recently have already been trading at around 5-1/8 per cent. Nevertheless, if the funds rate were to move to the 5-1/2 per cent upper limit of the range specified for alternative B, market participants would undoubtedly interpret this as another significant step toward policy firming, with consequent effects on other interest rates.

Under alternative A, since the top of the range specified for the Federal funds rate is only 5-1/8 per cent, money market pressures could actually slacken a bit. As market participants began to realize that the System was not attempting to firm money market conditions further, views on the near-term interest rate outlook would very likely be modified. But maintenance of the alternative A specifications would run the risk that not enough firmness had been induced to bring about the eventual moderation in monetary growth desired by the Committee.

In conclusion, I would like to comment briefly on one aspect of the earlier discussion this morning regarding the relationship between money supply growth and interest rate expectations. During recent months, as M_1 growth has exceeded the prospective Committee targets reported in published policy record entries, participants in securities markets have understandably concluded that the Committee would try to slow down the rate of growth in M_1 by tightening money market conditions. Since March this expectation has in fact been consistently confirmed. From its March low the Federal funds rate has now advanced nearly 200 basis points, and other short-term rates have risen commensurately. Most recently, with monetary growth remaining large, market participants continue to anticipate a further firming of money rates and this expectation is being reflected in the behavior of other rates.

Of course, current levels of long-term rates also reflect to some extent the monetarist view that recent rapid money supply growth will lead to rapid economic expansion and a consequent return to tight money in 1972. These monetarist expectations can be sustained, however, only so long as they are confirmed by the unfolding of economic events. If, as time goes by, the emerging data suggest that the economy is moving more along the lines of this morning's staff presentation, the current monetarist expectations will begin to be called in question and long rates should behave about as the staff has projected.

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

It seems to me that the determination of monetary policy today should not be unduly difficult. The basic conditions which led to the Committee's unanimous decision at the last meeting "to moderate growth in monetary aggregates over the months ahead, taking account of developments in capital markets" are still controlling. Although the unemployment rate remains disturbingly high, with only modest improvement in sight over the coming year, the progress in curbing inflation has been most disappointing, the balance of payments situation remains critical, and on the whole the monetary aggregates have continued to grow at extremely rapid rates. While short-term interest rates are still far below their year-ago levels, they show a substantial rise from mid-March lows, and this rise has helped materially to improve the atmosphere in the foreign exchange markets.

Under these circumstances, it would seem appropriate to seek money market conditions that would support a continuing effort to slow the growth of the principal money measures. A proximate target of at least 5-1/4 per cent for the Federal funds rate would appear suitable, with probing toward a somewhat higher level if this could be accomplished without undue disturbance to the capital markets. Such probing would be essential if the aggregates should seem to be expanding even more rapidly than currently projected. I recognize that the possibility of borrowing at 4-3/4 per cent at the discount window may make difficult any attempt to push the Federal funds rate much above its present level. The specifics I have in mind are not far from those in the blue book associated with alternative B, which is the directive I would favor. Since the Treasury will be announcing a major refunding operation around July 21, it would be well to accomplish the further firming of money market conditions that I have in mind within the next couple of weeks or so.

With respect to the discount rate, a very good case can be made for increasing the rate during this same period in view of the fact that market rates have been moving up and that even-keel considerations would probably make a discount rate change undesirable from mid-July until about mid-August. However, in my judgment the important thing is to obtain some further firming of short-term market rates in order to moderate growth of the aggregates; and there may be good reasons to avoid at this particular time whatever criticism the System might invite through a discount rate increase.

I continue to feel, as I have for some time, that it might be wise to remove the interest ceilings on large certificates of deposit. Admittedly, there is some risk that this might be construed as a sign of easing of policy, but I think this could be prevented by an appropriate announcement, and it might well prove increasingly difficult to deal with this problem in the event that continuing economic expansion should force the adoption of a firmer monetary policy over the coming months. If a move were to be made on Regulation Q, this would strengthen the case for an increase in the discount rate, with the latter clearly negating any intention to move to greater ease.

Mr. Francis commented that so far this year the money stock had grown at more rapid rates than at any other time since World War II. In the weeks following every Committee meeting since

January the money stock had risen more rapidly than called for by the policy directive.

Chairman Burns asked whether that had been the case for the period since the last meeting.

Mr. Holmes replied that in the last few weeks both M_1 and M_2 had been slightly below the paths contemplated at the time of the previous meeting. Of course, those paths involved rather high growth rates--higher, he believed, than the Committee would have preferred were it not for the problems of reducing them.

Mr. Francis went on to say that at each subsequent meeting, rather than reaffirming the desired growth rate, the Committee had raised the target rate of money growth that was acceptable. The alternative growth rates of money discussed in the blue book prepared for the early-June meeting were all far in excess of anything that had been discussed or even contemplated during prior meetings. At today's meeting, the Committee was given three alternative annual rates of increase in M_1 for the third quarter: 8, 9, and 10 per cent. By comparison, money had risen at an average rate of 5 per cent since 1964, a period of accelerating inflation.

As had been discussed on many occasions by this Committee, Mr. Francis continued, there were two alternative indicators of the thrust of monetary actions on over-all economic activity. One was the level or trend of short-term interest rates and the other was the growth of various monetary aggregates. For some time the Committee's objectives had been expressed in terms of both of those indicators. It seemed to him that the Committee's targets had been fairly successfully achieved in terms of movements in short-term interest rates, even though there had been upward movement in rates in recent months. In his view, however, the success in achieving a target in terms of money market conditions had been at the expense of allowing market forces to play a large part in the determination of the growth of monetary aggregates.

For those who relied more on aggregates than on the level of interest rates as indicators of the future trend of economic activity, Mr. Francis said, it was very unsettling that System actions had combined with market forces to create a growth rate of the money supply that no one had previously indicated as desirable. In his view, the monetary stimulus provided to the economy in the first half of 1971 implied substantial upward pressure on interest rates through much of the remainder of this year. As the delayed effects of those monetary actions became reflected in growing demands for credit, the outlook for a continued high rate of inflation in the foreseeable future, as expressed by leaders in the business community, indicated to him that upward revisions in price expectations might well keep pace with the actual rate of inflation as the economy continued to strengthen. If so, the inflationary premium built into nominal market rates of interest would get larger as total spending continued to respond to monetary stimulus.

As Mr. Francis saw it, the only way to avoid such a sequence of events was for the Committee to direct that the growth of money be sharply reduced for the balance of this year. The temporarily sharply higher short-term interest rates that would likely result from such actions would simply have to be tolerated as a necessary cost of avoiding a renewed round of accelerating inflation.

Mr. Fossum remarked that economic conditions in the Sixth District were not as disappointing as he gathered they were nationwide; there had been more plus than minus signs in the District recently. For example, loan demand in the District seemed to be stronger than in the country as a whole, and the unemployment figures were considerably below the national average.

In his judgment, Mr. Fossum continued, interest rates had been rising recently mainly because of expectational factors. At the outset of today's meeting he had thought he would probably support alternative C for the directive, in view of the fact that forthcoming Treasury financing operations left relatively little time for the Committee to move toward somewhat greater restraint. However, in light of today's announcement on fiscal policy--which he thought would tend to diminish public fears that the

Administration was not prepared to fight inflation--he considered alternative B to represent a more appropriate posture for monetary policy.

Mr. Fossum added that while a case could be made for an increase in the discount rate, this morning's announcement regarding fiscal policy would seem to make such action inappropriate at this time.

Mr. Melnicoff observed that the consensus of both the directors and the staff of the Philadelphia Reserve Bank paralleled rather closely the views that had been expressed by Mr. Francis today. They had been fearful that a continuation of the rapid rise in M_1 that had been experienced in the past few months would eventually bring about the very conditions the System wanted to avoid--a resurgence of inflationary expectations and consequent difficulties in bringing long-term interest rates down. The directors and staff of the Bank had also been sensitive to the need to avoid continued increases in unemployment, and they did not want to take any monetary actions that would result in an unacceptable situation in that area. At the same time, they thought the unemployment problem was in large part structural in nature and that some new efforts outside of monetary policy were required to deal with it.

Mr. Melnicoff remarked that he was disturbed by the arguments that the recent large increments to the money supply had been absorbed by increased desires for liquidity or by higher prices. While such arguments might be valid on an _ex post_ basis, they were not very helpful in looking ahead; to permit money to expand rapidly because prices were rising was likely to set in motion a circular process in which prices would continue to rise. Accordingly, he would like to see moderation in the rate of growth of money. Either alternative B or C might be appropriate for the directive, depending on whether the third-quarter projections of the New York Bank or the Board's staff were considered more likely to be realized. However, in light of the fact that even the Board's staff projected that under alternative B growth in the aggregates would decline to an acceptable rate by the end of the year, he would favor that alternative.

With respect to the discount rate, Mr. Melnicoff observed that the directors of the Philadelphia Bank still had in mind recent policy statements to the effect that the System would vary the rate more frequently than in the past to keep it more closely in line with market interest rates. For various reasons, however, the System apparently had abandoned that policy during the past few months.

Chairman Burns said he thought it would be more accurate to say the policy had been suspended rather than abandoned.

Mr. Melnicoff remarked that he would consider that difference to be significant. If the System had merely suspended the policy, he thought the Reserve Banks should base their discount rate recommendations during the next few weeks on the reaction to the Administration's fiscal policy announcement of today, and on the degree to which the rate of advance in the money supply appeared to be moderating.

Mr. MacDonald said the sluggish recovery was expected to continue during the second and third quarters at rates well below the economy's productive potential, and the projected growth path in the forecasts of both the Cleveland Bank's staff and the Board's staff offered little prospect for a meaningful reduction in unemployment over the next four quarters. Moreover, the sluggish performance of output over the months ahead might hinder the further productivity gains that were the key to continued moderation of the rise in unit labor costs in view of the continuing large wage settlements. As a result, prospects for curbing cost-push inflation were not encouraging.

In that environment, Mr. MacDonald continued, it was apparent that expansive public economic policies were needed to accelerate growth in output. In his view, regardless of the Administration's announcement this morning, some fiscal actions were the appropriate source of the additional stimulus. Monetary policy, however, should not attempt to provide any further stimulation; in fact, the recent growth rates of the monetary aggregates had been excessive. He had been in agreement with the Committee's recent program to moderate the growth rates of the aggregates at the cost of small increases in the Federal funds rate. He urged continued moderation and believed that a 6 to 8 per cent growth path for the narrowly measured money supply was an appropriate goal, with consistent target paths for the other aggregates. Any more stimulative monetary policy would tend to reinforce inflationary expectations and add to a reasonably ample supply of liquidity. Until the next meeting, alternative B of the draft directives seemed to represent a further step in the Committee's recent efforts to reduce growth in the aggregates to more appropriate rates over the third and fourth quarters without generating an unacceptable increase in interest rates.

Mr. Sherrill said the situation facing the Committee today seemed to be much the same as at the last meeting, in the sense that the real economy remained in a condition that would call for stimulation were it not for the problem of inflation. Now that the Administration had announced its intentions with respect to fiscal policy and wage and price controls, the question arose as to what monetary policy could do to meet the conflicting goals of stimulating activity and moderating inflationary pressures. Ideally, the System would continue to provide stimulation while incurring as small a risk as possible with respect to inflation; the difficulty was in finding means to do so.

In his judgment, Mr. Sherrill continued, it was necessary to continue efforts to moderate the growth of M_1; a failure to do so would be interpreted by the financial community and by the public at large as signifying an abandonment of concern about inflation, and that would have counter-productive effects on expectations. Moreover, continued rapid growth in the monetary aggregates might generate further inflation. Although he was still uncertain about the strength of that effect over the longer run and about the lags that might be involved, the risk seemed sufficiently great to hedge against, insofar as it was possible to do so without sacrificing the long-term objectives for the economy. However, he would want efforts to moderate growth in the monetary aggregates to be carried out in a very gingerly fashion.

Mr. Sherrill observed that the alternative B policy course seemed to come the closest to that which he had been describing. It would be desirable to reduce the growth in M_1 to the rate associated with that alternative, or even to the rate specified under alternative C, if that could be done without causing a further run-up of interest rates. He would favor probing toward a Federal funds rate of 5-1/2 per cent, but moving very slowly while keeping a close watch on the behavior of the monetary aggregates. If it appeared that growth in M_1 would not exceed the rates associated with alternative C--9-1/2 per cent in July and 8 per cent in the third quarter--he would want to permit the funds rate to stabilize or even to retreat a little.

Mr. Brimmer said he favored alternative B for reasons similar to those advanced by Messrs. Hayes and Sherrill. In one respect, however, he would differ with Mr. Sherrill. He thought the economic situation had changed somewhat since the preceding meeting; there now seemed to be a little less strength in activity, and a little more inflation. In his judgment the Committee should wait a bit longer before moving more vigorously than called for by alternative B to moderate growth in the aggregates. He agreed with Mr. Partee that the Administration would not necessarily hold indefinitely to the position it had announced today. At its next meeting the Committee should have a somewhat better view of the outlook for fiscal policy.

Mr. Maisel commented that the main conclusion he had drawn from the staff's excellent presentation today was that there still was a need for a positive monetary policy. Contrary to the views of some that current monetary policy was inappropriate, the staff's analysis made clear that it was the proper policy. Perhaps the most interesting point was one made in the discussion of the stimulative alternative; namely, that if there was stimulus to activity from some exogenous force--the staff discussed fiscal policy, but it could be some other force--somewhat greater monetary growth would be required if monetary policy were not to be operating against that force and inadvertently tending to offset it. It was important for the Committee to keep that point in mind.

In his judgment, Mr. Maisel continued, a directive along the lines of alternative B would be appropriate. He was somewhat concerned, however, that the language of the draft reading "the Committee seeks to moderate growth in monetary aggregates over the months ahead" might be interpreted as implying dissatisfaction with the alternative B growth rates. He thought those growth rates should be taken as targets and that operations should be modified if there were significant deviations in either direction. Clarification on that point would be useful in light of the shortfall of M_1 in the latest week and in light of the fact that the New York Bank projections for coming months were below those made at the Board. The clarification might be made by revising the language in question to read "the Committee seeks to achieve more moderate growth in monetary aggregates over the months ahead."

Chairman Burns asked whether there would be any objections to such a revision, and none was heard.

Mr. Maisel then referred to the earlier dialogue between Mr. Mitchell and the staff regarding the comparative implications for monetary policy of growth rates in M_1 and of other types of indicators. That discussion raised the question of whether the

Committee was placing too much emphasis on M_1 relative to the other aggregates--a question he thought the Committee would want to consider in the future.

In the coming period, Mr. Maisel said, he would urge the Manager to seek money market conditions in the area of overlap between those specified for alternatives A and B--which was about where conditions were now. It was possible that the desired moderation of growth, as shown in the alternative B projections, could be achieved without any further firming.

Mr. Daane said he was very much concerned about the outlook for the economy generally, for prices, and for the balance of payments. He would favor language for the second paragraph of the directive that reflected such concern. The language he had in mind, which might be labeled "alternative D," took as its point of departure the last sentence of the first paragraph, which read "In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments." His proposal for the second paragraph read "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to attaining bank reserve, credit, and money market conditions consistent with the above-stated objectives of policy, provided that somewhat firmer conditions shall be sought if it appears that the monetary and credit aggregates are significantly exceeding the growth paths expected and capital markets are not under excessive pressure."

Mr. Daane observed that he continued to hope that the Committee could disabuse the public and the market of the notion that it focused on one aggregate--M_1--and on one money market measure--the Federal funds rate. He would like to see long-term interest rates come down and the monetary aggregates tranquilized. On the latter score, he would be pleased if the growth rates projected by the New York Bank were achieved. However, he would not want to accept any particular growth rate as a target, nor to react strongly if such a growth rate were exceeded. In any case, to his way of thinking interest rates were more germane to the state of the economy at the moment than were the aggregates.

In a final comment Mr. Daane said he was inveighing more against the format than the spirit of alternative B.

Mr. Mitchell remarked that in his judgment alternative B was about as good a policy as the Committee could adopt at present. He wanted to say a word about Mr. Maisel's proposal for a symmetrical response to upward and downward deviations of M_1 from the alternative B growth rate. He had not found very persuasive the staff's response to his question about the implications of evidence as to the stance of monetary policy other than the rate of growth of the money supply. On the other hand, he thought that M_1 should be tranquilized, if only because the market believed in the validity of the monetarists' thesis; and that the real question was how much tranquilization the Committee was prepared to live with. The growth rates the staff recommended for the third and fourth quarters--9 and 7 per cent, respectively--closely approximated the rate of increase they projected in GNP and consumer spending over the second half, which implied little change in turnover. Bearing in mind that turnover tended to rise secularly by 2 or 3 per cent--although the advance had been smaller recently--and also considering the desirability of compensating for the excessive growth in M_1 in the second quarter, he could accept an M_1 growth rate as low as 4 or 5 per cent. Certainly, he hoped that there would be no repetitions of the 15 per cent growth rate recorded for May.

As to the discount rate, Mr. Mitchell recalled that when the System committee on the reappraisal of the discount mechanism had discussed the matter there had been no sentiment in favor of abandoning the use of the rate as a means for transmitting signals to the market. For the Federal Reserve to take no action now would indicate to the market that the System considered expectations of rising interest rates to be mistaken. In his judgment such a course would be wise and completely consistent with the conclusions of the committee on the discount mechanism.

Mr. Heflin commented that he came out almost exactly where Mr. Sherrill had. As he saw it, the Committee's problem today remained one of finding an orderly way to return the aggregates to a moderate growth path. He believed that, given the prevailing economic and financial climate, that was a task that would require time and had to be approached with patience. The blue book suggested that the current degree of money market pressure might well reduce growth in the aggregates to moderate dimensions by the fourth quarter. He would consider that a satisfactory outcome. But he had to express some skepticism here, with respect to the admitted deficiencies in the forecasting art as well as in the state of knowledge regarding lags in the relationship between money market conditions and the growth in the aggregates.

Mr. Heflin added that he was more impressed by the evidence that inflationary expectations were on the rise and with the possibility that those expectations could keep long-term markets on edge. The possible connection between inflation psychology and the publicity being given the rapid growth in the aggregates was especially disturbing. Under the circumstances, and with projected third-quarter growth in the aggregates still excessive, he thought the Committee should pursue somewhat further its recent efforts to slow money and credit expansion. He liked the specifications of alternative B, although he would instruct the Desk to move cautiously and with a view to minimizing the resulting upward pressure on long yields. That move would clearly increase the chances of a general hike in the prime rate, but if that hike were held to a quarter of a percentage point he would not expect it to do serious damage to the bond markets. He would definitely oppose any action on the discount rate at this time. Like Mr. Mitchell he thought that the System had not given up use of the discount rate as a means of transmitting signals, and that an increase now would transmit precisely the wrong kind of signal.

Mr. Clay expressed the view that the problems and dilemmas of monetary policy formulation had remained essentially unchanged. The financial aggregates continued to grow at rates that were excessive, while interest rates had risen sharply and were sensitive to further upward movement. A faster and broader-based economic recovery would be desirable, but continued expansion in the financial aggregates at the current pace would threaten rather than facilitate orderly economic activity and price stability in the months ahead.

Over the near term at least, Mr. Clay said, the desired goals for the financial aggregates and for interest rates were in conflict, and that presented a real dilemma. There was no way by which monetary policy could bring the growth rates in the aggregates back to appropriate levels promptly without repercussions in the money and capital markets and in the national economy that appeared to be unacceptable. Unless the Committee was persistent in its pursuit of more moderate growth rates in the aggregates, however, there was a high risk that the dilemma would become more rather than less acute, with the ultimate consequences to the national economy still more severe. That did not mean that it should be the aim of the Committee to seek higher interest rates. However, it did mean that the Committee had to stand ready to accept somewhat higher interest rates that might result from efforts to bring about more appropriate growth rates in the financial aggregates.

For the present, Mr. Clay continued, that approach might be undertaken by the adoption of alternative B of the draft directives.

Mr. Mayo said he would not add to the comments already made regarding the dilemma facing the Committee at present. It might be worth noting, however, that three weeks ago the Committee had adopted a policy course with specifications for money market conditions not very different from those given under alternative A today, but with projections of growth rates in M_1 for July, August, and September of 14.5, 8.5, and 5.0 per cent, respectively, compared with current projections under A of 10, 10.5, and 9 per cent. The magnitude of the changes in the monthly projections in just three weeks suggested that at best the Committee would simply be adopting a prayerful stance if it relied on the staff projections of a marked slowing of M_1 growth in the fourth quarter, or on the New York Bank's projections of significant slowing in the third quarter. He hoped the New York Bank's projections proved more realistic than those of the Board's staff, but that was only a hope.

Mr. Mayo went on to say that he shared Mr. Daane's sense of frustration about the emphasis on monetary aggregates in the Committee's policy directive. The Committee was in a box largely of its own design. He had thought that the Committee was finding its way out of that box earlier in the year, when it was placing primary emphasis on money market conditions in its directive. However, market rates were declining at that time; it was more difficult to make the same reversal of emphasis under present conditions, when rates were rising.

Mr. Mayo said he would be willing to accept Mr. Daane's proposed alternative D for today's directive, except that he would prefer in the proviso clause to refer to the growth paths "desired" rather than to those "expected." He also would find alternative B acceptable, if the Committee were to decide that under present circumstances it should maintain the emphasis on the monetary aggregates. He would hope, however, that at some later point the directive would be reformulated into the more broadly-based type of statement that he would consider preferable.

Mr. Strothman said that, like Mr. Mayo, he would not further comment on the dilemma facing the Committee except to observe that he found himself impaled on a different horn from that on which the others at the table were found. He continued to believe that the System should strive for an unemployment rate in the neighborhood of 5 per cent--and, more importantly, rather sooner than was likely if it pushed for a 6 or even a 7 per cent rate of growth for M_1. Against the background of several years of inflation, the sort of ease needed to reach a 4 per cent unemployment rate any time soon could well be associated with unfortunate results. But the Committee should go part way; and there was a considerable difference, in social terms at least, between unemployment rates of 5 and 6-1/2 per cent.

According to the Board's staff and the majority of outside experts, Mr. Strothman continued, the rate of inflation would not differ much from that currently expected even if a substantially lower path for the unemployment rate were to be sought. At the present point in time the inflation-unemployment trade-off favored deference to the unemployment data.

All that, Mr. Strothman observed, was by way of saying that to him the extremely high second-quarter increase in M_1 was not alarming. A return to a more reasonable unemployment rate required, for a time yet, a considerably more expansionary fiscal policy than even now could be counted on; and even with such a policy, it required a growth rate for M_1 perhaps in the 8 to 9 per cent range. Until some form of tax reduction was at hand, a 9 to 10 per cent target value for M_1 could be acceptable. It certainly was much more acceptable to him than was the prospect of prolonged unemployment at present or higher levels, relieved only by a possible temporary stopgap along PWA lines.

Thus, Mr. Strothman remarked, he came out for alternative A of the draft directives. Of course, alternative B was better than C. If alternative B was the Committee's choice, in his judgment the Manager should be urged to increase the Federal funds rate only gradually and to strive generally to stay in the lower half of the range indicated in the blue book in connection with alternative B.

Mr. Strothman observed that the blue book noted the possibility that rate ceilings for large-denomination CD's might become effective again, although admittedly only if alternative C were adopted. He suspected some might be tempted by the prospect of inducing a considerable capital inflow. Even with his concern for the U.S. balance of payments, however, his hope was that rate ceilings for large-denomination CD's would never again be effective. And now would be a good time, it seemed to him, to ensure that they were not. With M_1 having increased markedly in recent months and with interest rates generally having advanced sharply, financial market participants seemed to be considerably more apprehensive than they had been earlier. Suspension of rate ceilings could reassure them. By suspending ceiling rates, the Board might take the edge off the market rate increases of recent months and, to the extent that firms had been hedging against extreme rationing of bank loans some time in the future, it might exert modest downward pressure on long-term market rates.

Mr. Swan remarked that, for reasons others had already expressed, he also believed that attention should continue to center on the objective of moderating growth of the aggregates. He would prefer alternative B for the directive. If it turned out in the weeks immediately ahead that the aggregates were growing a little less rapidly than anticipated under that alternative, he would not want the Desk to try to offset that shortfall.

Mr. Swan then said that he would suggest a revision in the draft of the first paragraph of the directive, affecting the statement that "growth in the bank credit proxy remains moderate." He was not persuaded that the word "moderate" was an accurate characterization of the June growth rate, which was currently estimated at 7-1/2 per cent. It was also worth noting that a 15.5 per cent rate was projected for July. He would prefer to make an objective statement, such as "growth in the bank credit proxy remains below the first-quarter rate."

The Chairman asked if there were any objections to that change, and none was expressed.

Mr. Coldwell commented that he had come to today's meeting with the question in mind as to whether a change in monetary policy could contribute to lower unemployment, reduced inflation now and later, greater stability in international financial markets, and reduced capital outflows. In his judgment the Committee's prime focus should be on reducing inflation. It should be recognized that such a focus would involve costs in the short run but would yield benefits in the long run. He agreed with Mr. Daane's comments today; indeed, he would carry them further and recommend a policy aimed at money market conditions conducive to a sharp cutback in the growth rates of the monetary aggregates, smaller reserve injections, and stability in market conditions to foster a climate of reduced inflationary expectations. At the same time, he would caution the Committee against an overreaction to recent high growth rates in the aggregates, which in themselves were partly a consequence of the Committee's earlier overreaction to the shortfalls of the fourth quarter of 1970.

It seemed to Mr. Coldwell that the Committee had to supply some leadership with respect to interest rates, rather than letting them move about in response to changes in expectations reflecting the latest money supply figures. He would recommend moving the Federal funds and bill rates into a 5-1/4 to 5-1/2 range and then holding them there for a while to provide a sense of stability to the market.

Mr. Morris said he agreed with the great majority today that the most prudent course for policy at this time would be to follow the middle road reflected in alternative B. He thought it was necessary for the Committee to demonstrate its intent to slow the rate of growth in the aggregates. Whether one liked it or not the market took a monetarist view of policy, and the adoption of alternative A could very well have an adverse effect on expectations. But, while the Committee had to convince the market that it was concerned about the growth rate of the aggregates, he would not want to go to the extreme represented by alternative C. So abrupt a move was likely to have significant effects on the flow of new mortgage commitments, which would be particularly unfortunate since at present residential construction activity was the main source of strength in the economic recovery.

Mr. Morris remarked that he agreed with Mr. Maisel that the target for the funds rate should be kept in the lower part of the 5 to 5-1/2 per cent range specified under B as long as the aggregates were on path. He would recommend holding the target in a 5 to 5-1/4 per cent range, not moving up to 5-1/2 per cent unless the aggregates were substantially above path. It should be possible to transmit the desired message to the market at this juncture without setting a 5-1/2 per cent target.

With respect to the discount rate, Mr. Morris noted that at their meeting yesterday the directors of his Bank had voted unanimously to reestablish the existing rate. Their reasons were much like those Mr. Mitchell had offered today; basically, they considered the current state of interest rate expectations to be incompatible with prevailing economic conditions, and they thought it would be unwise to indicate to the market that the System viewed those expectations as correct.

Mr. Robertson said he would submit the statement he had prepared for inclusion in the record, and say only that he saw nothing in today's announcement regarding the Administration's intentions with respect to the fiscal policy to require a change in monetary policy. Like others, he favored alternative B; but he differed from those who advocated some specific target for the Federal funds rate. In his judgment the Committee should use the funds rate merely to provide signals indicating that it was moving too fast or too slow in trying to reduce the growth of the aggregates.

Mr. Robertson's prepared statement read as follows:

> Everything I have read and heard about economic developments since our last meeting seems to me to add up to one policy conclusion: that we should continue on the course of determined but orderly pressure to slow down the growth of the monetary aggregates.
>
> Concerns have been expressed about this or that potential difficulty in financial markets, with the consequent suggestion that our operations be modified accordingly, even if it means some diversion from our basic policy objective. But I believe our need for concrete progress toward our basic objective is sufficiently important--and the current condition of financial markets is sufficiently resilient--so that

> we should press ahead with our campaign to slow down the growth of the aggregates, with fewer inhibitions over the short-run market side effects.
>
> What we need to do, I believe, is agree on the aggregate targets we wish to seek and ask the Desk to control carefully the volume of reserves it supplies with the view of approximating those aggregate targets as closely as feasible. In this approach, the Federal funds rate becomes not a target or objective but simply a short-run indicator of relative reserve supply as the market perceives it. In my view, we should not be seeking at this time to push the funds rate up or down but simply let it give us signals as to whether we are moving too fast or too slow in reducing the growth rate of the aggregates.
>
> Of course, we should proceed with prudence in achieving this objective, not so much because of any accompanying interest rate movement but because of the risk that if we tighten too much we may unduly depress the aggregates in the fall. Such lagged effects must be taken into account if we are not to "oversteer" the monetary machinery; and hence, my policy preferences would seem best served by the language of directive alternative B as drafted by the staff.

Chairman Burns said his own thinking on policy ran along much the same lines as that of the majority today. Accordingly, he would make only a few brief comments. He might note first that the Board had again begun to discuss Regulation Q, and that it would welcome the views of Reserve Bank Presidents. He had found helpful the comments on that subject that had been made in the go-around this morning.

Secondly, the Chairman continued, he shared the view that the public was tending to exaggerate the importance of the monetary aggregates. In his judgment the best way to deal with that problem was through written articles and speeches by System officials. Not enough had been done along that line recently.

Finally, the Chairman said, like others he was disturbed by the large differences between the projections of the monetary aggregates made at the Board and at the New York Bank, and by the frequent sizable revisions in those projections. At the same time, he was heartened by the fact that the two staffs made no attempt to compromise their differences; each relied on its own best judgment, even though to do so was to disclose deficiencies of knowledge or method. That procedure was highly unusual among Government agencies, as he could attest from many years of observation.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft of the first paragraph with the change suggested by Mr. Swan, and alternative B for the second paragraph with the modification Mr. Maisel had proposed.

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

> The information reviewed at this meeting suggests that real output of goods and services is expanding moderately in the current quarter and that the unemployment rate has remained high. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in both consumer prices and wholesale prices of industrial commodities has stepped up again recently after moderating earlier in the year. In June, according to tentative estimates, the money stock both narrowly and broadly defined is still growing rapidly on average, although less than in May;

growth in the bank credit proxy remains below the first-quarter rate. Interest rates on most types of market securities have increased on balance in recent weeks. The market exchange rate for the German mark has advanced, and a substantial flow of funds from Germany to other markets has occurred in recent weeks. In consequence of a partial reversal of the earlier speculative outflows of short-term capital from the United States and of an increase in Euro-dollar borrowings of U.S. banks, there has been a surplus in the U.S. payments balance on the official settlements basis in this period. The U.S. merchandise trade balance, which had been in small surplus in the first quarter, was in deficit in April and May. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.

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

Chairman Burns then noted that the Committee had planned to discuss today the question of the information on current monetary policy that might be given to Reserve Bank directors in connection with their establishment of the discount rate. He observed that a draft letter to Reserve Bank Presidents, outlining a possible approach to the subject, had been distributed to the Committee on June 4, 1971. Subsequently, on June 25, there had been distributed a revised draft that had been discussed at the

June 23 Conference of Presidents.[1/] The Chairman invited Mr. Francis to open the discussion.

Mr. Francis said he personally had never felt that the Reserve Bank Presidents had much of a problem in deciding what information on current policy they could reveal to their directors; it had always been recognized that there were areas of discussion which were to be held strictly within the Open Market Committee and not disclosed at board meetings. The approach that had been employed at his Bank was to begin with a briefing on the business situation by the Bank's economic staff, and follow with a statement by the President. The President would give his interpretation of the situation and his recommendations, in the process providing as much information on current monetary policy as he considered appropriate. That approach had worked well, and he had nothing additional to suggest.

Mr. Hayes said he understood that the question at hand had initially been raised at the Conference of Reserve Bank Chairmen last winter, in the course of a discussion of the kinds of information on current policy the directors should have as a basis for their actions with respect to the discount rate. Over subsequent months the Committee on Discounts and Credits of the Conference of Presidents had worked with Chairman Burns and

1/ Copies of these materials have been placed in the files of the Committee.

Mr. Holland on the matter, and had had the benefit of comments from several other Presidents. The final outcome of those efforts was the revised draft of a possible letter to Reserve Bank Presidents that had been distributed a few days ago. It had been the unanimous view of the Presidents at their meeting last week that the revised draft reflected the type of guidance that would be appropriate. However, the Presidents had not been unanimous on the question of whether it was necessary to send a letter of this kind.

Mr. Hayes added that he personally did not have strong feelings on that question. He did feel, however, that the revised draft embodied a satisfactory statement regarding the information on current policy that could be transmitted to directors.

Mr. Clay said he thought it had been useful to review the matter under discussion. Like Mr. Hayes, he considered the position set forth in the revised draft to be acceptable. At this point, however, he believed nothing would be gained by sending a formal letter to the Presidents, and that something might well be lost. What concerned him was the fact that the draft commented not only on information that should not be revealed to the directors, but also on information that should be revealed; and it was possible to conceive of circumstances in which it would be inappropriate to reveal some information in the latter category. All things considered, now that the subject had been reviewed he thought it would be best to rely on the judgment of the Presidents. In effect, the letter had already served its purpose.

Mr. Robertson noted that while the letter might have served its purpose as far as present System officials were concerned, those officials would be succeeded by others in future years. He believed it would be desirable to send the letter in order to provide a record of the conclusions that had been reached in the course of the current review. Such a record also would be helpful in responding to inquiries that might be received from Congress regarding the type of information on current policy that was given to the directors of Reserve Banks.

Mr. Swan said he agreed with Mr. Clay that a formal letter to the Reserve Bank Presidents, however it was phrased, might raise more questions than it resolved. At the same time, he shared Mr. Robertson's view that it would be desirable to have a record of the conclusions reached. Such a record could be made without sending the letter, by incorporating in the memorandum of discussion prepared for today's meeting the substance of the revised draft and noting that it had been concurred in by Reserve Bank Presidents and Board Members.

The Chairman asked whether there would be any objection to such a course and none was heard.

The following paragraphs set forth the conclusions reached by Reserve Bank Presidents and Members of the Board of Governors regarding the question of providing sufficient information about the stance and trend of Committee policy at meetings of directors of the Federal Reserve Banks to assist them in effectively discharging their statutory responsibilities in the establishment of Federal Reserve Bank discount rates.

"It was agreed that it is important to distinguish between the different statutory responsibilities of the FOMC on the one hand and the directors of the Reserve Banks on the other, and, in this connection, to avoid giving more information to the directors than is necessary, in order to minimize any possibility of conflicts of interest or even appearances of such conflicts. In steering a responsible course in this delicate area, there was agreement on the desirability of a reasonably uniform approach by the Presidents of the Reserve Banks in providing their directors with background information related to the Committee's proceedings. Accordingly, the following understandings were reached.

"The presentation of business and credit data, both as to method and content, and the analysis of that data, both retrospectively and prospectively, are matters for determination by each Reserve Bank President and the Bank's board of directors. On the other hand, the practices followed by the Presidents in providing information as to Committee policy should be reasonably uniform at each Reserve Bank. In this respect, each President should feel free, at meetings of his Bank's directors and if he considers it desirable, to comment on the sense of the Committee's staff's views on the general economic outlook as he understands them from attendance at Committee meetings. In the event that the Committee's staff's views are discussed at meetings of the directors, it should be made clear that those views are an informed judgment of the staff and not necessarily official Committee views.

"In commenting on recent data on various aggregates and on money market conditions, the directors can be informed in a very general way as to whether or not developments have followed the expectations of the Committee and, if not, the general nature and area of the divergence. In this respect, it would appear desirable for each Reserve Bank to furnish its directors regularly with copies of the latest published policy records of the Committee as they are released.

"In giving the directors information in this way, care should be exercised so that the directors obtain merely a very general idea of the thrust of recent policy. Thus, at meetings of directors, the Presidents and members of their senior official staff could identify, in a broad or general way, a shortfall or an unexpected surge in the aggregates, or unusual credit market developments, and could take account of such information when formulating a specific recommendation with respect to the discount rate.

"It should also be made clear to the directors that even these broad and general references to FOMC policy must be held in the strictest confidence and that they should be so guided in exercising their responsibility as Reserve Bank directors."

Mr. Brimmer noted that as the Board member responsible for the voluntary foreign credit restraint program he had sent a letter on June 24 to the Reserve Bank Presidents dealing with some problems that had arisen in the administration of that program. He added that if a bill now pending in Congress to exempt export credits were enacted, it would become considerably more difficult to achieve an appropriate degree of restraint on bank credit to foreigners. Personally, he thought it would be desirable in that event to place substantially more restraint on other types of foreign assets, although he recognized that doing so might well create difficulties in dealing with the banking community. He would keep the Presidents informed of developments in that connection.

Chairman Burns added that while the Board had discussed the matter it had not yet reached a decision regarding the appropriate course if export credits were in fact exempted by legislation.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, July 27, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

June 28, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 29, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services is expanding moderately in the current quarter and that the unemployment rate has remained high. Wage rates in most sectors are continuing to rise at a rapid pace. The rate of advance in both consumer prices and wholesale prices of industrial commodities has stepped up again recently after moderating earlier in the year. In June, according to tentative estimates, the money stock both narrowly and broadly defined is still growing rapidly on average, although less than in May; growth in the bank credit proxy remains moderate. Interest rates on most types of market securities have increased on balance in recent weeks. The market exchange rate for the German mark has advanced, and a substantial flow of funds from Germany to other markets has occurred in recent weeks. In consequence of a partial reversal of the earlier speculative outflows of short-term capital from the United States and of an increase in Euro-dollar borrowings of U.S. banks, there has been a surplus in the U.S. payments balance on the official settlements basis in this period. The U.S. merchandise trade balance, which had been in small surplus in the first quarter, was in deficit in April and May. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining prevailing money market conditions; provided that somewhat firmer conditions shall be sought if it appears that the monetary and credit aggregates are significantly exceeding the growth paths expected and if capital markets are not under excessive pressure.

Alternative B

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

Alternative C

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with substantial moderation of growth in monetary aggregates over the months ahead.