MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Monday and Tuesday, June 19 and 20, 1972. The meeting began at 4:15 p.m. on Monday.

PRESENT: Mr. Burns, Chairman
Mr. Brimmer
Mr. Bucher
Mr. Coldwell
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Mitchell
Mr. Robertson
Mr. Sheehan
Mr. Winn
Mr. Treiber, Alternate for Mr. Hayes

Messrs. Francis, Heflin, and Mayo, Alternate Members of the Federal Open Market Committee

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hexter, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Bryant, Gramley, Green, Hersey, Hocter, and Kareken, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors

Mr. Sammons, Associate Director, Division of International Finance, Board of Governors
Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mr. Zeisel, Associate Adviser, Division of Research and Statistics, Board of Governors
Miss Stockwell and Messrs. Ettin and Taylor, Assistant Advisers, Division of Research and Statistics, Board of Governors
Mrs. Junz, Assistant Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Messrs. Enzler and Peret, Economist and Senior Economist, respectively, Division of Research and Statistics, Board of Governors
Mr. Roxon, Senior Economist, Division of International Finance, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Mr. Merritt, First Vice President, Federal Reserve Bank of San Francisco
Messrs. Parthemos, Scheld, Andersen, Tow and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Mr. Bodner, Vice President, Federal Reserve Bank of New York
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Mr. Cox, Senior Financial Economist, Federal Reserve Bank of Atlanta
Mr. McNees, Economist, Federal Reserve Bank of Boston

Chairman Burns welcomed Mr. Jeffrey M. Bucher, recently appointed to the Board of Governors, to his first meeting of the Federal Open Market Committee.[1/]

1/ Mr. Bucher had executed his oath of office as a member of the Committee prior to today's meeting.

The Chairman then noted that the Committee had agreed to hold an extended meeting beginning this afternoon to provide more time for a staff presentation on economic prospects through 1973 and for Committee discussion of the presentation.

Mr. Partee began the presentation with the following introductory statement:

> The economic and financial projection that we will be presenting today extends through the end of 1973 and thus covers a longer time horizon than the normal one-year span. Such an extension exposes the projection exercise to much more than the usual amount of uncertainty, particularly at this time of year when very few spending units have made firm plans for 1973. Nevertheless, we believe that a longer-than-normal projection will be most useful to the Committee at this juncture, for two reasons.
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> First, the economy this year has just begun to close the gap between actual and potential GNP. The question on everybody's mind is whether, and if so how soon, economic policy will need to face the "re-entry" problem--that is, the problem of gradually slowing real growth from the rapid rate anticipated during the remainder of 1972 to a rate consistent with our long-run potential, which would be 4 per cent or so. Given current resource utilization rates, it seems clear that that problem is still some distance away; it is much more likely to be an issue for the second half than the first half of 1973. But the possible shape of the "re-entry" trajectory, as it develops next year, is an important consideration in planning the strategy of monetary policy during the intervening period.
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> Second, incorporating the possible effects of large tax refunds next spring--because of overwithholding this year--tends to give an exaggerated impression of the underlying strength of consumer demands. It is desirable, therefore, to take into account the post-refund period as well.
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> The monetary policy assumption underlying the projection is that M_1 will continue to grow at the 6 per cent rate that has characterized the past 2-1/2 years. This may seem relatively high for a period of vigorous

economic expansion, but it must be interpreted in the context of a nominal GNP that continues to be inflated by a substantial uptrend in costs and prices. Thus, 6 per cent money growth is very likely to be accompanied by tightening credit conditions as the projection period progresses. Later on, I will offer our judgments on the possible impacts if alternative rates of monetary growth are assumed.

For fiscal policy, we have projected outlays in fiscal 1973 that run $2 billion or so over the $250 billion figure presented in the midyear budget review. This allows for about a $2 billion overage in defense spending to cover the escalation of bombing and naval activities in Vietnam, and for a 12-1/2 per cent increase in social security benefits. But we also anticipate that outlays will fall short of the budget in a few areas--mainly in the size of the fiscal 1973 revenue sharing package and in unemployment compensation payments.

We have also had to make an assumption for the projection about the wage-price control program. Since the legislative authority terminates in April of next year, we have assumed that the program will be phased out in early 1973. We have done this mainly because there is no solid basis at this juncture for assuming that the program will continue. But it is important also, for policy purposes, to try to assess the extent to which termination of the program may intensify the inflation problem as economic recovery proceeds.

Mr. Gramley made the following comments on prospects for economic expansion:

Judging by a variety of indicators, there has been a gathering of momentum in the economic expansion since last fall. Industrial production has been rising briskly, sparked by increased durable goods output--especially business capital equipment, which has grown at an 11 per cent annual rate over the first 5 months of 1972. Total man-hours worked in non-agricultural establishments have been rising steadily since last September, at an annual rate of around 4-1/2 per cent, reflecting a lengthening workweek as well as increased numbers of employees. Retail sales rose further in May, continuing the strong advance in physical volume that began last August. Construction expenditures, of course, have flattened out with the reduction in housing starts from the February peak. But the latest figures show new starts rebounding to 2.3 million units, annual rate, in May; shipments of mobile homes, furthermore, increased 7 per cent further in April to a record annual rate of 635,000 units.

Leading indicators of trends in economic activity suggest that the recent strong pace of expansion will continue--and perhaps accelerate. Total new orders for durables, paced by increased demands for capital goods, have been rising rapidly since December of last year. The accession rate in manufacturing has risen markedly, while the layoff rate has declined, suggesting that manufacturing firms are gearing up for still higher levels of output. The rate of net business formation has risen about 10 per cent from a year ago, and the composite leading indicator, which blends together a variety of economic and financial time series, has continued to show a vigorously rising trend.

Such advance indicators as these provide useful insights as to the direction and strength of recovery in the near term--that is, over the next 3 to 6 months. But they are of little assistance in forecasting what might happen in 1973. To develop our GNP projection for next year, therefore, we have relied more heavily than usual on our quarterly econometric model, but we have also tried to sift the record of prior cyclical performance for clues as to how key sectors of private demand might behave.

Perhaps the most important element of all is the prospective course of business fixed investment outlays. Average experience in past cycles suggests that it would not be unreasonable to project a continued rise in the rate of real capital investment through the end of next year. But there has been substantial diversity of experience from one cycle to the next. Thus, real investment turned down after 8 quarters in the 1958-59 expansion; in the 1961-64 period, strong growth was still occurring after twelve quarters. There is no good reason for expecting a downturn in business fixed investment outlays soon, but any point estimate of the probable rise next year is bound to be highly uncertain.

As for inventory investment, the current recovery has been quite unlike its three predecessors. The shortfall of inventory investment in the current recovery reflected, until recently, a comparatively sluggish pace of final sales. In fact, the aggregate inventory-sales ratio fell a little less in the first year of this recovery than it did, on average, in the previous three. But inventory-sales ratios recently have dropped significantly, setting the stage for an upturn in the rate of inventory accumulation. If the pace of final sales is sustained, therefore, a substantial thrust to general business activity from inventory building would be likely.

In the other major area of private investment--residential construction--we have seen a rate of growth during this recovery that has outstripped considerably the typical rise in this stage of recent business cycles. The increase in home building since mid-1970 has been so rapid, in fact, as to raise serious doubts as to its sustainability. Demand factors alone would probably lead to at least a moderate reduction in residential building--especially apartments--over the next 4 to 6 quarters. But the extent of the decline will depend importantly on mortgage credit supplies--as they are influenced by developments in credit markets generally and by the ability of the depository institutions to attract savings flows.

A simple way of summarizing developments in credit markets, and relating them to monetary policy, is to consider the relation between the income velocity of money and short-term interest rates. In the short-run, increases in the income velocity of M_1 (currency and demand deposits) normally are accompanied by increases in short-term interest rates. The rise in yields is what is required to encourage the public to stretch its cash balances further.

The relation between velocity and Treasury bill rates is far from perfect. Velocity has been rising sharply since last fall, during a period of declining bill rates. Past experience strongly suggests, however, that unless M_1 begins soon to grow at a rate close to the growth rate of nominal GNP, short-term interest rates will go up.

Our projection of nominal GNP will be discussed shortly. Suffice it to say here that projected growth in GNP exceeds by a considerable margin the assumed 6 per cent rate of growth of M_1. We are, therefore, projecting a rise in bill rates--beginning in the third quarter of this year and carrying up to around a 6-1/2 per cent level by the end of 1973.

Before such a level of bill rates was reached, net inflows of consumer-type time and savings deposits to banks and nonbank intermediaries would begin to dwindle--indeed, they would be likely to decline rather substantially, given the ceiling rates that the institutions are currently permitted to pay. The highest certificate rate payable--for 2-year money--is 5-3/4 per cent at banks and 6 per cent at non-bank intermediaries. We believe these institutions can pay more than they are now paying, given the improvement in their earnings position during recent years. Our projection of time deposit inflows assumes, therefore, that the ceilings on all certificates (but not passbook savings) will be raised by 50 basis points, effective by the time of the March-April interest-crediting date. With such a change, net savings inflows--though still declining--could be relatively well sustained, and the impact of rising market interest rates on mortgage credit supplies and on housing over the forecast period would be moderate.

Mr. Wernick made the following comments regarding the GNP projections:

A key problem in evaluating economic trends for 1-1/2 years ahead is the uncertain course of fiscal policy. The midyear budget review implies an ambitious effort to hold down expenditures and there are no official estimates as to what fiscal 1974 will bring. The timing and amount of tax refunds available in early 1973 are likely to have an impact on consumer spending but there are few guides as to what the order of magnitude will prove to be.

There is also substantial uncertainty regarding the impact on Federal expenditures of major bills now pending in Congress. It does seem clear, however, that Federal expenditures will be stepped up over the next half year. Enactment of a revenue sharing bill, higher social security benefits, and greater defense costs account for a large share of the projected increase. In the first half of 1973, tax refunds will reduce receipts while a Federal pay increase and rising non-defense outlays will act to push up expenditures, even though defense spending may be moderating.

Tax refunds and the rise in Federal expenditures will result in a significant step-up in the NIA deficit, especially in the first half of next year when it is expected to exceed $30 billion. A marked improvement is expected in the second half of next year, as refunds are completed and revenues rise in response to growth in the national income. Nevertheless, the NIA budget deficit is likely to be at close to a $15 billion annual rate.

Although the pickup in Federal expenditures in the last half of this year will contribute to economic expansion, the major thrust, in our view, comes from the momentum now evident in the private sectors.

Consumer spending is expected to be an important source of rising final demands. The surge in retail sales in recent months has allayed fears that overwithholding of taxes would seriously depress consumer outlays. Improving job and income prospects, and the further reduction in tax rates stemming from the 1969 and 1971 tax reform legislation, have apparently dampened the influence of overwithholdings on spending. Gains in consumer spending are projected to accelerate through the middle of 1973. For the remainder of this year increases are mainly associated with continued strengthening in employment and earned income, and higher social security payments.

Lightening of the tax load in the first half of next year is estimated to add $13.5 billion, at an annual rate, to disposable income. However, the tax refunds may not result in a dramatic upsurge in consumer spending or in the economy generally. Based on studies of the fragmentary evidence available, we estimate that only about half of these special income receipts are likely to be spent. The quarterly increase in consumption, therefore, rises to about $20 billion in the first half, and the savings rate spurts to about 9 per cent. Once the period of tax refunds has ended, the rise in spending is projected to slow significantly, and the savings rate to decline.

Also underlying our generally bullish outlook is the expectation of a fairly smooth and sustained rise in business fixed investment. The 12-1/2 per cent increase in business fixed investment projected for this year is based on the continued strength shown in new orders for capital equipment and recent surveys of anticipated plant and equipment spending. Fixed investment is projected to increase in 1973 at close to this year's rate. We think businesses will continue to emphasize investment in labor-saving equipment in an environment of rising profits and larger internal cash flows, and also the need for additional capacity should be on the increase. Our econometric model yields results close to those we are projecting.

Although the projected rise in business fixed investment in real terms is not of boom proportions, the gain would be larger than in the comparable stage of recent recoveries, mainly reflecting the continued influence of the investment tax credit and accelerated depreciation schedules. Our projection is rather close to developments in the 1961-64 recovery, when tax incentives apparently did help to sustain gains in investment over a prolonged period.

With both consumer and business capital spending projected to rise rapidly, a significant rebound in inventory investment is anticipated, and in fact is necessary if the buoyancy we foresee for the economy is to be realized. Inventory investment, so far, has been very sluggish, especially in view of recent accelerated gains in final sales. As a result, inventory-sales ratios have fallen to the lowest levels since early 1966. Prospects are for further large gains in final sales over the next year--we have projected a 10 per cent increase. Thus, we feel that businesses will be revising their desired inventory levels upward. We expect inventory investment to increase to a $16 billion dollar rate by early 1973 and have held it at close to that rate for the remainder of next year. A rise of this magnitude, although coming later in the cycle than usual, would not be out of line with those in previous recovery periods and would maintain inventory/sales ratios at near the current levels.

In contrast to most other sectors, housing activity is not expected to contribute to aggregate growth. Housing starts are projected to decline from the peak first-quarter 1972 annual rate of 2.5 million units to about 1.9 million units in the latter part of 1973. Much of the slowdown anticipated reflects the effects of rising vacancies in multi-family units accompanying the recent surge in residential building. But we believe mortgage credit conditions will also be contributing to a less vigorous housing outlook. With the flow of savings to mortgage lending institutions slowing somewhat as short-term interest rates rise, the supply of mortgage funds will be restricted somewhat, resulting in some tightening in mortgage lending terms, including interest rates.

Our appraisal of prospective developments in major sectors adds up to an appreciable expansion in over-all activity. We are projecting GNP gains of over $30 billion in each of the final two quarters of this year, reflecting the rebound in inventory investment, continued strength in business fixed investment, and stepped-up consumer spending. Going into 1973, quarterly gains in GNP are expected to remain large but to moderate somewhat during the course of the year, as housing expenditures slacken and the rise in inventory investment levels off.

Real GNP growth is projected to reach a high of over 7.5 per cent later this year but then to recede somewhat to a 4.3 per cent rate in the latter half of 1973--a rate which would be about in line with the economy's longer-run growth potential.

With the higher rates of growth of real GNP over the next year and a half, stimulated largely by widespread increases in demands for goods, industrial production would be expected to grow at an accelerated rate. We are projecting an increase of about 10 per cent (annual rate) in the second half of 1972 and a continued rise somewhat in excess of real GNP growth during 1973. Such an outcome would imply a further strengthening in demand for labor, especially in the cyclically volatile manufacturing component.

Mr. Zeisel commented as follows on the outlook for prices and wages:

The resurgence in economic growth has been reflected in a sharp acceleration of employment gains since late last summer. At first the pickup was largely confined to nonmanufacturing sectors. But just before the turn of the year, manufacturing employment began a strong rise, although it still remains substantially below its 1969 peak.

The rapid rate of growth in real output anticipated over the next four quarters will be well above any likely rise in productivity, and employment gains should thus continue large. We are projecting a rise in over-all employment of almost 2-1/2 million from mid-1972 to mid-1973, including about three quarters of a million in manufacturing. But the increase in employment is projected to moderate in the latter half of 1973, as the rate of real GNP growth slows.

Thus far, the recovery has brought no reduction in the unemployment rate, an unusual situation six quarters following a cyclical trough. At first, the lack of improvement was attributable to the sluggishness of the economic recovery. More recently, the continued high rate of unemployment has reflected a rapid expansion of the labor force, paralleling the gain in employment. The extra labor force increase occurred mainly among females, whose participation in the labor market tends to be relatively sensitive to the availability of employment opportunities.

We expect a continued rapid increase in the labor force over the next year, for several reasons. First, the population of working age is in a period of accelerated growth, the result of the large numbers of children born after World War II. Second, the proportion of women in the labor force has been trending sharply upward; every year has shown an increase in participation rates except during the recent slowdown, when the lack of job opportunities was undoubtedly a major negative factor. The increasing participation of married women with children of school age has been a characteristic of the American labor market for several decades. More recently there has also been a sharp rise in the participation of younger women under 25, reflecting mainly a shift toward later average age of marriage and smaller family size. With demands for labor again strong, continuation of these longer-term growth considerations in conjunction with some post-recession recovery in participation rates suggests a labor force increase of about 2 million over the next year. This would be well in excess of the approximately 1-1/2 million that we would normally expect in less expansive situations. By the second half of 1973, growth in the labor force should return to a more normal pace.

Nevertheless, the projected strong employment gains outstrip the still rapid rise in the labor force through mid-1973. The unemployment rate is thus expected to drift down during the next year, and then level off at about a 5 per cent rate in the second half of 1973 when more moderate job gains will again just about equal labor force growth.

The availability of ample labor resources, in conjunction with the influence of Pay Board standards, has apparently resulted in a slowing of the uptrend in average hourly earnings. This is particularly evident in the relatively less unionized service and trade sectors, where earnings increases in recent months--following the post-freeze bulge--have dipped to annual rates under 5 per cent, below the Phase II goals. The slack in the labor market has apparently had less impact on wages in manufacturing. The rate of increase in manufacturing earnings appears to be averaging 5.7 per cent in the second quarter of this year--judging by April-May data--which is about 1 per cent below the rate of rise in the pre-freeze period of January to August last year.

We expect hourly earnings to advance somewhat more rapidly during the remainder of this year. The backlog of negotiated wage rate increases awaiting Pay Board action provides substantially larger increases than those recently approved, and a large number of deferred raises are coming due which should average close to the Pay Board's outside limit of 7 per cent. In trade and services, improved demand for labor may be expected to result in a somewhat larger wage rise than reported in recent months.

Looking ahead further, another bulge in wage increases seems likely next spring, particularly since wage and price regulation is assumed to terminate in April. Next year begins another cycle of heavy contract negotiations, with the teamsters, electrical workers and autos the most notable reopenings on a 1973 schedule over 50 per cent larger than this year's. Moreover, the continuing rise expected in consumer prices, with attendant erosion of buying power, will inevitably generate pressure for large contract settlements. The size of wage increases should tend to rise further in nonunion sectors as well, reflecting an expected increase in the minimum wage as well as improved labor market conditions. With the over-all unemployment rate projected to drop to 5 per cent, some slack will be gone from the job market, and unemployment rates for experienced workers and for heads of households are likely to drop to relatively low levels.

The rise in compensation per manhour--which also includes fringe benefits and white collar earnings--is projected to edge up from now on, reaching an annual rate of almost 7 per cent for the private nonfarm economy during the second half of 1973. This year the impact on costs should be partly offset by a continued strong rise in productivity, associated with the projected rapid increase in output. We expect an annual rate of productivity gain of about 3-3/4 per cent in the next two quarters. On balance, then, the rise in unit labor costs may slow further later this year to about a 2-3/4 per cent rate. Next year, however, growth in productivity is likely to moderate as gains in real output slacken, and with larger increases in compensation in prospect, the rate of rise in unit labor costs is projected to move up to about 4 per cent in the second half of the year.

We expect prices generally to move in line with unit labor costs. During the remainder of this year, price controls and the easing of cost pressures are expected to result in some moderation of nonfood commodity price increases. Although less certain, some slowing of the rise in food prices also seems probable. The annual rate of increase of the fixed-weight private GNP price index is expected to edge down to about 3-1/2 per cent, as compared to 4 per cent in the first half.

The prospects for prices appear less favorable for 1973, however. Mainly because of the expected pattern of labor cost increases, nonfood commodity prices may begin to accelerate, and service prices also seem likely to be under increased pressure. Termination of Phase II controls would act to heighten the problem, although the upward pressures would undoubtedly be developing in any event. In the absence of restraints, there might well be an attempt to widen profit margins in an environment of rapid expansion. In addition, some employees whose wages have been held down by Pay Board regulations might be able to negotiate catch-up increases in the strengthening labor market conditions envisioned. On balance, therefore, we expect the over-all GNP price index to move up somewhat more rapidly in the latter half of the year--averaging about a 4-1/4 per cent rate of increase.

Mr. Hersey made the following comments on the balance of payments:

Between last August and the time of the Smithsonian meeting, despite various actions by foreign governments to discourage capital inflows, speculative outflows from the United States on top of the large underlying deficit in the balance of payments brought a further sharp rise in U.S. reserve liabilities. In the next three months, to the middle of March, there were recurrent speculative flurries, but the over-all deficit in that period was not as large as before. Since then, there has been a small surplus, which indicates that short-term capital inflows in various forms have been exceeding the underlying deficit.

In the first quarter the deficit balance on current account and long-term capital was at an annual rate of \$13 billion, about equal to that of the worst period, July to September, last year. The balance of private long-term capital flows had become less unfavorable, because direct investment outflows were smaller and the inflow of funds to buy U.S. stocks was larger. But there was a further worsening in the trade balance. The lessening of the over-all official settlements deficit was due partly to a reversal of the rundown in balances due to commercial banks abroad, and more importantly to unrecorded transactions; the accounts show a positive amount of errors and omissions in the first quarter. Probably this means, among other things, that a reversal of last year's shift in leads and lags in commercial payments has begun. For example, some of this year's unusually large imports were probably already paid for last year.

By March, or at least by April, the merchandise trade figures were probably no longer greatly distorted by effects of port strikes. Exports, at a rate of about \$45 billion, were showing a 12-month rise of only 4 or 5 per cent in value and even less in real volume, substantially below the long-term growth trend because of the economic slowdown in Europe and Japan that began in 1970. Imports, however, were still surprisingly high. At nearly a \$54 billion rate, they were almost 20 per cent above the rate in the first half of 1971, which in turn was up 15 per cent from the first half of 1970. In volume terms, the 12-month growth rate had stepped up from about 10 to about 13 per cent. Partly, this high level in March and April must be due to the strength of U.S. domestic demands for consumer durables, but it is possible that we are seeing a persistent bulge, due to advance ordering last year, that will still wear off as the year goes on. So far, last year's exchange rate realignment seems to have had little effect on import demand; the rise in average U.S. dollar prices for imports of finished manufactures seems not to have accelerated significantly, which seems to imply that some foreign sellers, despite rising costs, have been cutting prices in terms of their own appreciated currencies. This is not surprising in view of last year's economic slowdown abroad.

In attempting to foresee developments over the next 12 to 18 months both in foreign trade and in international capital movements, we need to form a view of economic conditions abroad--though it is not easy to generalize. In the European Economic Community, the slowing of growth in the past 2 years has not produced any great freeing of resources, and wages and prices in several of the countries are still rising more rapidly than in the United States. After the Smithsonian meeting there was a definite upturn in activity. The further expansion of European activity generally expected, moderate though it will be, will be steadily taking up the slack in resource utilization and increasing the demand for capital equipment. These conditions, plus the changes in exchange rates, should help our exports eventually. However, in these circumstances, European monetary policies will be shifting toward restraint, which will not be helpful for our capital account. In Japan, the projected rate of increase in industrial production at 8 or 9 per cent a year is far slower than in earlier years; this would be associated with a slowing of export growth. Policies are likely to aim at stimulating Japanese domestic demand and reducing the huge Japanese trade surplus.

The staff projections of U.S. imports and exports assume a dip in imports this summer and a consequent early narrowing of the enormous trade deficit. Our projections are generally in line with the results of recent interagency discussions modified only a little in the light of our projections for the U.S. economy. The reasoning with regard to the import dip is not that the new exchange rates are going to produce quick results, but rather that there may still have been heavy temporary bunching of imports in March and April, perhaps reflecting not only delays due to port strikes but also heavy ordering last year in anticipation of the exchange rate changes. Later this year, given the outlook for the domestic economy, fairly rapid growth in the value of imports is expected to resume, and continue into next year, because the substitution of domestic products for imports, which the exchange rate changes tend to promote, will be a very slow process. Export growth should tend to accelerate next year, under the double impetus of tightening demand-and-supply conditions abroad and the improvement in the competitive position of U.S. exporters that should stem from the exchange rate realignment if U.S. costs and prices behave as projected.

Along with the projected narrowing of the trade deficit, some improvement is to be expected in the course of 1972 and 1973 in the "services" category, broadly defined. The balance on services is projected to rise from about $3 billion, annual rate, in the present half year to double that in the latter part of next year. Half of this gain would be in net receipts of investment income and royalties. Transportation and travel receipts, combined, would rise somewhat more than U.S. expenditures abroad on those accounts. There might also be a moderate decline in U.S. military expenditures abroad. Meanwhile, the net outflow of private long-term capital may be running this year and next at a rate of perhaps $2 billion, somewhat more than the average in the years 1966 to 1970, but far less than the $6 billion annual rate in the first three quarters of last year.

Last year's worsening in the balance of private long-term capital flows was in great part due to a slackening in three types of capital inflows: foreign purchases of U.S. corporate stocks, foreign direct investments in the United States, and U.S. corporations' long-term borrowings from banks abroad. The first two of these in particular were greatly affected by the expectations of depreciation of the exchange value of the dollar against other currencies. For the same reason, U.S. corporations' direct investments abroad were unusually large in the first three quarters of 1971; but year-end reflows held down the direct investments net outflow for the year as a whole.

The inflow of funds to buy U.S. stocks has been highly variable. Last year's fourth-quarter recovery was in fact concentrated in December, and probably in the last dozen days of the year, after the Smithsonian meeting. Those purchases, and the large inflow in the early months of 1972, probably represented a catching up, after the very low level of buying most of last year. The projected average inflow in the period ahead would not reach levels attained in 1968, when for various reasons a major portfolio adjustment was occurring.

Interest rates here and abroad in the 3-month maturity sector have recently been bunched unusually closely together. After the end of November, the decline in Euro-dollar rates at first went parallel with declines both here and in Germany. In April and May, however, Euro-dollar rates declined while U.S. rates were rising. For overnight money, Euro-dollars have been cheaper than Federal funds so long as a bank does not maintain borrowings beyond its reserve-free base. The 20 per cent reserve requirement inhibits additional Euro-dollar borrowing by member banks, but does not affect the operations of foreign banks as intermediaries via their branches and agencies in this country, and at times there has been some inflow through the latter channel. Long-term interest rates abroad were generally declining last year, but this year they have been rising more than ours. During the rest of 1972 interest rates in Europe are more likely to rise than to decline, but there is at present no reason to expect any marked change in the relative levels of short-term rates here and abroad.

To sum up the staff's view of the balance of payments outlook for the rest of 1972 and on into 1973, the first thing to say is that the band of uncertainty is extremely wide in this period following a major exchange rate realignment. Secondly, if we have erred in our projection of imports, it is in the direction of understatement. We are projecting for next year a deficit on current account and long-term capital (private and government) of about $5 billion, far less than 1971's $9 billion but much more than the $2-1/2 billion average of the 5 years before that. Short-term capital flows, including reflows hidden in "errors and omissions," are likely to help hold down the overall deficit or even produce some surplus in coming months. We are not attempting a projection of the overall balance further ahead.

Mr. Partee made the following concluding comments:

The economic projection for the next six quarters that we have worked out represents a compromise among the various national stabilization objectives that must be taken into account. Thus, the expansion visualized in real GNP appreciably exceeds the long-run potential growth path, so that the unused resource gap is significantly reduced by mid-1973. But the projected rates of increase decelerate from 7-1/2 per cent in the last half of 1972 to 5-1/2 per cent in the subsequent half year and 4-1/4 per cent in the latter half of 1973, so that the objective of gradually reducing economic growth to a sustainable pace appears more readily achievable than I, for one, would have supposed.

The price and employment implications of this real GNP growth, however, would be far from optimal. The projected leveling off in the unemployment rate at 5 per cent is not good enough in terms of national social and economic objectives. And our judgment is that the rate of inflation would recede only to about 3-1/2 per cent before beginning to reflect the results of intensifying cost-push pressures and receptive product markets once again. The assumed termination of the wage-price restraint program by next April adds an increment of a few tenths to both costs and prices over the balance of the year, but the continued effectiveness of the program in an environment of rising employment and more buoyant markets would be subject to question in any event. With prices continuing to rise and domestic demands relatively robust, moreover, we do not expect any rapid or dramatic rebound in our net export balance.

Nevertheless, an important conclusion of the projection exercise is that the expansion in prospect, while substantial, is relatively orderly. This outcome results from projections of the major sectors of demand that are strong, but not ebullient, and that complement rather than compete with one another in terms of timing. During the second half of this year, we expect increased inventory investment to emerge as a key expansive factor, supplementing continued strength in consumption and a rising trend in capital investment. The standout performer in the first half of next year is likely to be consumption, buoyed by the tax refunds, while inventory accumulation may be leveling out and residential construction declining. In the second half of next year, the rise in consumption is expected to fall back to more normal levels, but business capital spending is projected still to be rising at a substantial pace.

What are the prospects that these patterns and degrees of strength will actually emerge? There obviously is room for quite a lot of variance, but I believe the patterns projected are not unreasonable.

Rising inventory investment is well behind schedule in terms of past cyclical timing. We are therefore expecting a substantial pickup soon, to a rate about in line with past experience. Business fixed investment, on the other hand, is about on track, and we anticipate a continuing uptrend in view of the ample flow of internal funds and the tax incentives to investment introduced over the past year or so. Housing has had a fine recovery, and some decline seems now to be in process. But we do not think that a sharp reduction is likely, given the backlog of demands that had built up throughout the country and assuming that mortgage markets do not tighten unduly. Finally, the projected strength in consumption occurs in the face of an upward movement in the savings rate; only after the unusual bulge in refunds is over next year does the savings rate subside, and then to only slightly below 7 per cent.

There are possibilities, of course, that we have underestimated the strength of the private demands that may in fact develop. If the timing of these successive stimuli turns out not to be so propitious as projected, the combined effects of, say, rapid inventory accumulation and a burst of consumer spending in the same period could lead to a general upward escalation in expectations, business spending plans, and output.

Another area of possible understatement is Federal expenditures. Expenditures are projected to rise a good deal less rapidly after the third quarter of this year than before, reflecting incorporation by then of past and immediately prospective programs in the estimated outlays. But there may well be other new programs not now foreseen that will continue to propel expenditures upward, and there may be less success than expected in holding down future spending under existing programs. What we have incorporated here are the mid-year budget review estimates, adjusted to include changes that we think most likely, but the evolution of Federal spending initiatives will bear close watching in the months to come.

As it is, the expected bulge in Federal financing requirements seems likely to put increasing pressure on financial markets through the spring of next year. Federal financing needs are projected to rise from a \$12-1/2 billion seasonally adjusted annual rate in the half year just ending to \$30 billion in the first half of 1973. This increases the projection of total funds raised to an annual rate of $156 billion in first half 1973, despite an expected downdrift in borrowings by all other sectors combined. Total funds raised do not rise relative to the GNP, but the ratio is very high by comparison with all but the last couple of years.

The principal reason for anticipating no further growth in private sector borrowing is found in the unusually favorable financial position of corporate business. Reflecting last year's change in depreciation tax rules, reinstitution of the investment tax credit, and rising business profits, the flow of internal funds is projected to rise sharply through 1973--as it has in recent quarters--in marked contrast to the lack of growth from 1965 to 1970. Meanwhile, corporations have greatly improved their liquidity positions in the past year and a half, and liquid asset ratios have risen for the first time in many years. Since the prospective rise in gross retained earnings parallels the projected expansion in investment over the forecast period, there is no growth in the need for external finance. Indeed, we are projecting a further drop in the volume of long-term financing, which still leaves room for continued substantial liquid asset accumulation.

Even so, the probabilities are high that interest rates will be rising over the projection period. The income velocity of money will be rising very substantially, assuming our GNP projection and a continuing 6 per cent growth in the narrow money supply. Such a development extending over any length of time has almost always required rising short-term interest rates. Moreover, we anticipate that households will now have to supply a considerably larger share of total funds raised directly, through the purchase of securities, reflecting both the much heavier Treasury borrowing in prospect and some moderate decline in savings flows through financial institutions. This also has usually required an increase in interest rates, though the anticipated increase in the household share of funds supplied directly is much less pronounced than in 1969.

Short-term interest rates are likely to rise considerably more than long, as they usually do and in view of the relatively moderate volume of long-term borrowing projected. Specifically, we would expect the Treasury bill rate to rise well above 5 per cent by year-end and further--to around 6-1/2 per cent--by the end of 1973. Over the same period, the Aaa new issue corporate bond index may climb to around 8-1/4 per cent, compared with 7-1/4 per cent currently. The projected rise in short-term rates is in line with the relationships produced by our econometric model, while the increase in long-term rates is consistent with our term-structure analysis but less than might be expected in an environment of rising inflationary expectations.

If rates do in fact move up as projected, the lack of competitive appeal of deposit-type instruments, given present ceilings, is likely to cause problems by early next year. As noted earlier, we have assumed an increase in ceiling rates of one-half percentage point on savings certificates in early 1973, to be utilized promptly by the institutions as they attempt to maintain their savings inflows. Even so, we would expect some decline in rates of deposit expansion. But the decline in inflows is moderate and should keep enough funds moving to the mortgage market to sustain housing finance at a reasonable level. It should be noted also that commercial banks would be expected to offset smaller consumer savings inflows in part through larger sales of negotiable CD's. This assumes that CD rate ceilings will not become a constraining influence--an assumption that is vital to the continuation of reasonable flows of bank funds into the municipal securities market. The projected growth in bank time deposits, along with expansion in money supply at a 6 per cent rate, will require a rate of growth in the private deposit reserves measure (RPD) ranging between 6-1/2 and 7-1/2 per cent by half-year periods, assuming no change in banking structure.

The Committee, of course, may wish to consider a longer-run policy that will produce a growth rate in narrow money at a rate faster or slower than 6 per cent, depending on its tradeoffs as to ultimate policy objectives or differences in its evaluation of the outlook for employment and prices. We have constructed some estimates, in terms of summary measures of economic performance, of the differences that alternative money growth targets might make. Limiting M_1 growth to a 5 per cent rate, we believe, would reduce the inflation rate somewhat in the latter part of 1973. But the cost would be a measurably slower growth in real GNP, and an unemployment rate that begins to turn up before it reaches even 5 per cent. Alternatively, permitting monetary growth to proceed at a pace consistent with expansion in M_1 at a 7 per cent rate should serve to raise real economic growth above our central projection, and would likely reduce the unemployment rate measurably below 5 per cent by the second half of next year. But the cost is likely to be a noticeably steeper uptrend in price performance.

If we could be certain that aggregate demand would be no stronger than projected next year, I for one would be sorely tempted to opt for the 7 per cent money growth path, hoping that something could be done to check upward price movements through an extension of the wage-price program. But we cannot be sure that some demand sector will not be appreciably stronger than we have projected, nor do we have any assurance that the continuation of a restraint program vigorous enough to be marginally effective is a viable political possibility. Therefore, I reluctantly conclude that 6 per cent money growth is the preferable path for monetary policy to shoot for, at least until we receive some stronger signals as to what 1973 will bring.

As it has turned out, achieving a money growth rate of 6 per cent has not been a particularly difficult chore in the quarter just ending. But given our projection of strong growth in nominal GNP, and with the Treasury about to re-enter the financial markets in volume, there is every indication that continuing to hold M_1 growth to a 6 per cent path will not be an easy task. The Committee is likely to be confronted with many difficult choices in the months and quarters ahead.

At the conclusion of the presentation, Mr. Partee noted that a number of staff experts were present in order to help answer questions from members of the Committee.

Chairman Burns remarked that the staff deserved the Committee's appreciation for its presentation. There necessarily was a great deal of uncertainty in any projections of real GNP for a period as long as a year and a half ahead. However, the Committee needed such projections and every member was familiar with the problems faced by the staff in preparing them.

At this point, the Chairman continued, the members might express their own views on the outlook and address any questions they had to the staff. He would open the discussion by noting that the balance of payments projections presented today were much more unfavorable than those the staff had presented around the turn of the year, and he found that disappointing. If the latest projections were correct, then the earlier estimates of the effects of the exchange rate realignment had been seriously in error.

Mr. Hersey observed that the more pessimistic balance of payments outlook was attributable to the recent performance of imports, which had increased far more than had been expected. Even on the assumption that imports had been showing a temporary bulge and would dip this summer, their total for 1972 was now projected at a level \$4-1/2 billion higher than that anticipated late last year. The difference apparently was partly a consequence of longer-than-hoped-for lags in the effects of the December exchange rate adjustments. In part, however, the difference reflected the often-demonstrated inadequacy of econometric techniques in this area; imports so far in 1972 were exceeding the levels projected on the basis of the determinants taken into account in the forecasting equations. However, the recent experience did not necessarily alter the outlook for the balance of payments in the latter part of 1973 and in 1974; rising economic activity abroad should expand exports, and U.S. producers should have had time by then to adapt production in order to take advantage of the new exchange rate relationships in competing with foreign goods in both U.S. and foreign markets.

In reply to a question by Mr. Daane, Mr. Hersey said it was not clear that observers had over-estimated the ultimate benefits for U.S. trade of the exchange rate realignment. What they may have over-estimated was the underlying strength of the U.S. trade position in the absence of a realignment.

Chairman Burns observed that the balance of payments projections really said more about the recent past than about the future, and Mr. Hersey agreed that they were highly uncertain.

Mr. Daane asked whether the performance of U.S. foreign trade would be expected to be materially better if prices were to increase at a rate below the 4-1/4 per cent rate projected for next year.

In reply, Mr. Hersey said it was very difficult to make judgments about the effects on trade of small differences in the rate of change of prices. One had to think in terms of thresholds of change in relative prices, or in exchange rates, beyond which trade in various manufactured projects would begin to be seriously affected; it might be that a very substantial change in relative prices would be required in order to make a decisive difference for some products.

Chairman Burns observed that it might be useful, if feasible, for the staff to check its balance of payments projections for the United States by making similar projections for major foreign countries and considering whether the two sets of figures were consistent.

Mr. Hersey noted that the OECD Secretariat made such projections for major countries. Their results indicated that over the near future a number of other countries would have sizable payments surpluses.

Mrs. Junz added that a large part of the surpluses the OECD Secretariat was projecting for other countries, especially Japan and Germany, was related to the cyclical situation in those countries. The underlying trend in the Secretariat's projections was quite favorable to the United States.

Mr. Partee observed that the approach suggested by Chairman Burns would involve substantial difficulties. The staff had a thorough knowledge of U.S. institutions and practices, and it spent a great deal of time in making projections for the U.S. economy; but it still had not been able to estimate reliably the level of imports in relation to any particular level of economic activity. The errors in the staff's projections of imports for other countries presumably would be as great or greater.

Chairman Burns said he realized that the results would be highly uncertain, but he thought it would be useful nevertheless to explore the approach in view of the importance of the subject. In particular, the U.S. negotiating team would be in a much better position in the forthcoming international discussions if it had balance of payments projections that were thought to be well founded.

Mr. Eastburn remarked that three separate meetings had been held at the Philadelphia Bank last week with a total of about fifty businessmen. Their general attitude about the economic outlook was not especially optimistic, despite the recent improvement in business conditions. They were worried about the rate of wage increases and inflation and about foreign competition. He was not sure how to interpret that negative sentiment; perhaps it reflected only a lag in reaction to current developments and would disappear shortly.

Mr. Eastburn then asked whether it was correct to infer from the projections that the staff expected the pressure of expanding demands to begin to affect the behavior of prices in the second half of 1973. If so, and if one assumed that the main effect of monetary policy was on demand, rather than on wages and costs, one might argue that it would be desirable for the Committee to seek growth in M_1 at a rate of 7 or even 8 per cent until late this year and then, in anticipation of the development of demand-pull pressures in the second half of 1973, to slow the rate of growth in M_1 in the early part of that year.

In reply, Mr. Partee commented that the price projections for next year reflected not only demand--and cost--influences but also the assumption made with respect to the wage and price controls. Demand pressures had already appeared for such commodities as lumber and foods, and they would appear in more and more sectors as economic activity continued to expand during the course of 1973. And, as

Mr. Zeisel had noted, the rise in unit labor costs was expected to increase during 1973 as the rate of increase in productivity moderated and the rise in compensation per manhour began to advance.

With respect to the wage and price controls, Mr. Partee continued, when faced with the difficult choice between assuming that the controls would be continued or that they would be terminated at the time the existing legislative authority expired in April 1973, the staff had decided in favor of the latter. At that point in time next April, prices were expected to be somewhat below a free-market level; their subsequent upward adjustment--reflecting business restoration of market-determined profit margins and catch-up increases in some wage rates--accounted for a few tenths of a percentage point of the projected rise in prices over the last three quarters of 1973. He noted that even if the controls were extended through next year the staff thought it would be increasingly difficult to enforce them because of the large number of collective bargaining agreements up for renegotiation and the expected expansion in aggregate demand.

Turning to Mr. Eastburn's question about monetary growth rates, Mr. Partee said that in view of existing lags a 7 per cent rate through the end of 1972 would probably lead to more of an inflation problem in late 1973 and in 1974 than a 6 per cent rate would. The projections suggested that monetary expansion through 1973 at a rate of 7, rather than 6, per cent would increase the rate of advance in the fixed-weight GNP deflator in the second half of 1973 by two-tenths of a percentage point, and perhaps by something more in 1974. However, the prospect that the faster rate of monetary growth would also carry the unemployment rate down further was certainly something the Committee would want to consider.

Mr. Mayo noted that the staff projections showed a shift in the behavior of inventories--which in this recovery had lagged behind their performance in other postwar periods of recovery--up to an annual rate of accumulation of $16 or $17 billion in each of the four quarters of 1973. That seemed to reflect an assumption that the recent sluggish performance would be compensated for later as final sales continued to expand. He doubted that inventory demand would be that buoyant in the face of substantial margins of unutilized resources and the greater computerization of inventory controls.

Mr. Partee commented that the staff's projections for inventories might well be too high, although he found it difficult to understand why the impact of computers would appear as abruptly as some observers were suggesting. In projecting inventories--and other sectors as well--the staff had used a variety of analytic approaches. First, it had looked at the results of the econometric model, which reflected a theory of inventory investment that had been tested against experience. Second, a staff expert on the subject had formed a judgment about the likely course of inventories through the projection period on the basis of an analysis of their behavior by industry group and by stage of fabrication, and in other ways. Finally, the staff had analyzed the behavior of inventories in other periods of cyclical expansion, as Mr. Gramley had indicated. All three approaches suggested a substantial increase in the rate of inventory accumulation in 1973.

Chairman Burns asked whether consideration had been given to the results of recent surveys of businessmen's inventory investment plans and whether such surveys seemed to have predictive value.

In reply, Mr. Partee said that the staff expert had considered the results of those surveys along with other information in judging prospects for inventory investment. In his (Mr. Partee's) experience, however, the surveys had never had much predictive value; they were less reliable than econometric projections.

Mr. Wernick observed that the survey results had been highly erratic over the past four quarters and had not provided much useful evidence on the likely behavior of inventories.

Mr. Mayo said he was particularly concerned with the influence of the degree of resource utilization on demands for inventories. It was his impression that expectations of shortages had been generated and inventory demands stimulated to a greater extent in the earlier more rapid recoveries than was likely in the current economic expansion.

Mr. Gramley noted that the projections implied a continuing decline in the ratio of inventories to final sales from its recent figure of 1.47 per cent to about 1.44 per cent toward the end of the projection period. He added that in the judgment of the staff expert it was more likely that the projections allowed for too little rather than too much inventory investment in relation to the expected rise in final sales.

Mr. Brimmer said the staff projections for a year and a half ahead provided precisely the kind of framework the Committee needed for its policy deliberations, and he was delighted to have them. However, he questioned the implication of the staff's analysis that the wage and price controls would have had very little lasting effect on the rate of inflation and the degree of resource utilization if they were removed in April 1973. Over the whole period from mid-1971 to the latter part of 1973, the rate of inflation was projected to decline from a range of 5 to 6 per cent to a range of 4 to 5 per cent, and the unemployment rate from 6 to 5 per cent. A key question in his mind was whether an assumption of a continuation of the control program throughout the projection would have resulted in projections of a lower rate of inflation and a higher rate of resource utilization by the final quarter of 1973.

Mr. Partee noted that an assumption of continuing controls would at least have the effect of excluding the catch-up increases which added 2 or 3 tenths of a percentage point to the projected rate of increase in prices, and 1 or 2 tenths to the projected rate of increase in wages, over the last three quarters of 1973. Beyond that, if it were assumed that the continuing control program could be effective, the projected rates of increase in wages and prices might be reduced somewhat further. As to the actual prospects for the program, the staff had no information on the Administration's plans and could speak only as outside observers. In his judgment the program was already in difficulty--it had been watered down repeatedly by Congress over the past 9 months--and it would meet still greater resistance from business over the coming 6 months to the extent that increases in profit margins were constrained. All things considered, it appeared to him that the probabilities were that the legislation would be permitted to expire next April.

Mr. Brimmer remarked that he was disturbed by the staff's projections, which suggested that roughly 4-1/2 million persons would be still unemployed at the end of 1973 and that rates of resource utilization would not have been improved very much. If that appraisal of the outlook were correct, it seemed to him that the task posed for monetary policy would be close to impossible. Moreover, the projections implied a substantial swing in the distribution of income in favor of profits and related income shares.

Mr. Partee said that the staff also was not happy with the employment and price implications of the projection, as he had noted in his earlier remarks. The calculations suggested that a higher rate of growth in real GNP, while lowering unemployment, would speed up the rise in prices; and that a lower rate of real growth, while slowing prices, would raise the rate of unemployment. As to profits, he agreed that the projections implied a sizable rise, but he believed the increase shown was about of usual cyclical dimensions.

Miss Stockwell added that the share of profits in total income ordinarily rose substantially when the rate of growth in the economy was as high as that being projected through 1973. That share customarily declined later in the cycle.

Mr. Mitchell remarked that it was difficult to express doubts about internally consistent projections such as those for GNP and the flow of funds, but he was puzzled by the projected behavior of interest rates. The flow of funds accounts indicated an increase in total funds raised from $101 billion in 1970 to $156 billion in 1971 and then a drop to $149 billion in both 1972 and 1973, and yet long-term interest rates changed little from 1970 to 1971 and were projected to increase by 50 basis points during the rest of this year and by a total of 100 basis points by the end of 1973. Moreover, the amount of funds raised by every sector except households was projected to be lower in 1973 than in 1971; the increase for households was hard to understand in view of the projected gain in household incomes.

In reply, Mr. Gramley observed that it was difficult to gauge interest rate pressures directly from the total amount of funds raised. In the past, a large rise in interest rates had often been associated with a decline in the total amount of funds raised; the amount of funds raised had declined precisely because credit markets had tightened. With respect to the pattern of credit demands, the staff had never been able to project the quantity of household borrowing with any degree of accuracy. For the period ahead, the GNP projection indicated a large increase in household purchases of durable goods, and that suggested a large increase in instalment credit and other forms of household borrowing. Mortgage borrowing by households also would be substantial, although it would taper down in association with the projected decline in residential construction. However, the principal reason for the tightening in credit markets over the projection period was a substantial increase in Treasury borrowing coupled with reduced foreign buying of U.S. securities at a time when inflows of funds to the depository institutions were projected to decline. Because the depository institutions would reduce their share of the funds being made available to purchase market securities, households would be required to increase their share substantially. In the past, a rise in the share of funds made available directly by households had proved to be a good index of interest rate pressures.

Chairman Burns observed, and Mr. Gramley agreed, that the staff projections had been based on an assumption of no change in taxes.

In reply to a further question by Mr. Mitchell, Mr. Gramley noted that Federal Government borrowing was estimated to have fallen to an annual rate of $12.5 billion in the half-year just ending. However, such borrowing was projected to rise dramatically--to annual rates of about $25 billion in the second half of 1972 and more than $30 billion in the first half of 1973--before declining to about $16 billion in the second half of next year. If those projections were near the mark, Federal borrowing would have a substantial impact on interest rates.

Mr. Mitchell observed that the interest rate implications of the staff projections depended on assumptions with respect to the income velocity of money as well as to the rate of expansion in M_1.

Mr. Gramley agreed. He added that if the demand for money declined significantly, the assumed 6 per cent rate of growth in M_1 would support the projected rate of growth in GNP without increases in interest rates. On the basis of past experience, however, the staff could not forecast such a decline in the demand for money.

In reply to questions from Mr. Mitchell concerning the consistency of the GNP and money flow projections, Mr. Partee noted that the rate of growth in the money supply was taken as given in developing both sets of projections and that otherwise the projections of flows of funds were based on the judgmental projections for GNP. However, the staff had assessed the implications for interest rates by looking at the household share of the funds supplied directly to the credit markets as well as at the income velocity of money. Both approaches suggested upward pressure on the rate structure.

Mr. Gramley commented that a substantial shift in the structure of household flows was involved. In the half year just ending households had sold securities at an annual rate of $12-1/2 billion, and the projections indicated they would have to buy at a rate of $19 billion in the second half of this year. That sharp turn-around in the household sector suggested that interest rates would rise. However, neither the figures on the household shares of funds supplied directly to the credit markets nor the figures on the income velocity of money yielded any precise indications as to how large the rise in interest rates would be.

Mr. Coldwell inquired about the details of the staff projections for personal consumption expenditures. He had the impression that expenditures for services were growing as a share in the total, but that did not seem to be implied by the projections.

In reply, Mr. Partee observed that over the long run the share of services in total consumer expectations had been tending to increase, mainly because prices of consumer services had tended to rise more rapidly than prices of consumer goods. However, such a tendency would not necessarily be discernible in a period as short as that covered by the projections. He noted that the staff had experienced great difficulty in making an estimate of the impact that next year's refunds of this year's overwithholding of taxes might have on consumption expenditures. The projections presented allowed for about half of the refunds to be spent over a period of several quarters, with a major share--around 30 percentage points out of the 50--going for durable goods. If one assumed, alternatively, that consumers would spend a significantly larger share of the refunds, the economy would be more buoyant than suggested by the staff projections. On the other hand, projections based on a permanent income hypothesis of consumer behavior would result in a much less buoyant economy in the first half of next year.

Mr. Daane said that he was troubled by the estimates presented by Mr. Partee in the last part of the staff presentation which implied that small differences in the rate of growth of narrowly defined money had a precise influence on the rate of change in prices and the level of unemployment. Those estimates did not appear to reflect any allowance for the effects that different policy courses would have on expectations and long-term interest rates, and he thought they did not make enough allowance for possible variations in the income velocity of money. In his view, the staff was attaching far too much importance to the specific growth rate in the narrowly defined money supply.

Chairman Burns observed that the staff might have presented a whole series of estimates based on different assumptions with respect to interest rates, Federal tax rates, and Federal expenditure levels, perhaps with variants reflecting the issuance next spring of the proposed tax refund bonds. He thought that the staff had limited itself to indicating the implications for prices and unemployment of different rates of growth in M_1 in the knowledge that Committee members would be discussing the desired rate of growth in M_1 in conjunction with desired rates for other monetary and credit aggregates.

Mr. Partee said that it was important to recognize that the staff first had worked through the judgmental projections for growth in real output, for prices, and for the unemployment rate, using every scrap of evidence available. Given those as central projections, the staff had then evaluated the deviations associated with rates of growth in the money supply both higher and lower than the 6 per cent rate assumed for the central projections. In presenting the results, however, they had not intended to suggest very precise relationships; they might have used ranges rather than specific values for the rates of growth in the money supply. In any case, each rate of growth specified for M_1 was intended as an index of the whole range of intermediate monetary variables; that is, each was associated with different rates of growth in M_2 and bank credit, and different levels of interest rates and patterns of money flows.

Mr. Daane noted that the staff's results implied that progressively more rapid rates of growth in M_1 would be associated with progressively lower interest rates. In fact, however, increases in monetary growth rates beyond some point were likely to lead to higher rather than lower interest rates.

Mr. Gramley agreed that very rapid monetary growth would result in expansion in nominal GNP and credit demands that at some point would be great enough to raise interest rates. In fact, the staff had experimented with the econometric model to determine the effects of pegging interest rates at current levels and allowing the money supply to grow at whatever rate was required, up to 10 per cent. The results of that experiment showed that, after only three quarters, expansion in nominal GNP and credit demands became so rapid that growth in the money supply was at the maximum allowed in the experiment and interest rates began to rise. However, he doubted that interest rates would rise more than allowed for in the projections if M_1 grew at a 7 per cent rate--the highest of the three alternative rates Mr. Partee had referred to.

In reply to a question from Mr. Brimmer, Mr. Gramley said the staff had not experimented explicitly to determine the rate of growth in GNP that would be required to reduce the rate of unemployment to 4-1/2 or 4 per cent. However, he believed that in the experiment he had just described, the unemployment rate fell below 4-1/2 per cent.

Mr. Partee observed that the analysis he had cited in the last part of the presentation suggested that the complex of credit conditions associated with growth in M_1 at an annual rate of 8 per cent would produce an unemployment rate close to 4-1/2 per cent by the end of 1973. However, those credit conditions also would have a direct effect on the rate of inflation and on expectations.

Mr. Treiber noted that some years ago the Council of Economic Advisers had suggested a 4 per cent rate of unemployment as a goal that could be achieved without substantial upward pressures on prices. He asked whether structural changes in the labor force and other developments since then made some other figure an appropriate goal.

Mr. Partee replied that he was not prepared to cite any specific level of unemployment as an appropriate goal at present, but he believed that any Council of Economic Advisers that had observed developments over the past decade would now hold that upward price pressures would be associated with a 4 per cent rate of unemployment. Because of structural changes in the economy, expansion in aggregate demand at a rate sufficient to reduce the over-all unemployment rate to 4 per cent would exert additional pressure on components of the labor force that already had low rates of unemployment. A 4 per cent rate of unemployment might still be a reasonable goal, but it could be achieved without significant inflationary pressures only through programs directed at the particular components of the labor force that had high unemployment rates. However, programs designed to deal with the structural problem and to change the utilization of the labor force generally required a long time to produce results, and it was not likely that anything could be done that would have much effect through the 18 months of the projection period.

In further comment, Mr. Zeisel said that manpower training and other programs over the past 10 years had accomplished relatively little to make the kinds of structural changes in the labor force that would shift the relationship between wages and the unemployment rate. Not very much was known about how to achieve the objective.

Mr. MacLaury asked what was implied for the gap between potential and actual output, which Mr. Partee had referred to in his concluding remarks, if structural changes in the labor force were required to achieve a 4 per cent rate of unemployment. If the size of the GNP gap still reflected an assumption of a 4 per cent rate of unemployment, then the gap could not be closed without the structural changes.

Mr. Partee said that potential output had been projected on the assumption of an unemployment rate of 3.8 per cent and growth in output at an annual rate of 4.3 per cent, which reflected productivity advance at an annual rate of 3.1 per cent. Because of the assumed rate of unemployment the gap was overstated, but raising the rate, perhaps to 4.5 per cent, would represent only a level adjustment and would not make a great deal of difference; at the end of the projection period output would be a little more than 97 per cent of potential rather than 96.5 per cent.

Mr. Brimmer asked what the flow of funds projections indicated for commercial bank borrowings in the Euro-dollar market in view of the anticipated increases in interest rates in this country.

Mr. Gramley replied that for the sake of simplicity in making the projections, banks were assumed to respond to the pressure of loan demand by obtaining funds in the CD market. The staff had not tried to draw out the implications for nondeposit sources of funds.

Mr. Partee commented that the projected amount of bank borrowing in the CD market was quite large and that it reflected also funds that might be obtained through the commercial paper and Euro-dollar markets. Whether the funds obtained through the Euro-dollar market, rather than through the CD market, resulted in a larger volume of bank credit or merely redistributed the total by banks was an unsettled question.

Mr. Heflin remarked that in his opinion the assumption that wage and price controls would be terminated in April 1973 was unrealistic in view of the projected behavior of both prices and the unemployment rate and in view of the wage contracts coming up for negotiation in 1973.

Mr. Partee replied that the staff viewed it more as an unhappy than an unrealistic assumption. It was quite possible that, as the expiration date of the legislation approached, a decision would be made to seek an extension of the controls. At this time, however, the staff thought that it would be useful to outline for the Committee the problems likely to be encountered in the event the controls expired on April 30.

Mr. Heflin asked what the staff had assumed about change in the minimum wage for purposes of the projections, and what it had concluded concerning the composition of unemployment in 1973.

Mr. Zeisel replied that the projections were based on the minimum wage proposal under consideration in the House of Representatives, which was small and would increase personal income by only $100 million this year and around $500 million in 1973. The proposal under consideration in the Senate contained a much larger increase.

Concerning unemployment, Mr. Zeisel said the composition was being altered by the rapid increase in the participation of women in the labor force. One result was that an over-all unemployment rate of 5 per cent, for example, now was likely to be associated with a rate of 2-1/2 per cent for adult males, rather than 3 per cent as in the past, which suggested that an over-all rate of 5 per cent now would carry with it a somewhat tighter labor market than formerly. The unemployment rate for black persons would tend to improve but it would remain high, and an influx of teenagers into the labor market would sustain their unemployment rate at a high level.

Chairman Burns said he would like to give his own interpretation of the staff presentation. For the sake of simplicity, two basic economic objectives had been assumed: full employment and a stable price level. To clarify the problems faced by the Committee in formulating monetary policy, the staff had assumed that the Government's incomes policy would be terminated next April and that its contribution to price stability would end early in the coming year; that Federal expenditures in the 1973 fiscal year would somewhat exceed those indicated in the mid-year budget review; and that tax rates would not be changed. Given those essentially unfavorable assumptions--which might or might not prove to be in accord with reality but were not obviously unrealistic--the staff had posed the question of what course was appropriate for monetary policy. Feeling dissatisfied with the projected rate of unemployment, the Committee might seek higher rates of growth in money and credit than either those of the recent past or those the Committee had been considering for the near future. On the other hand, to improve the performance of prices the Committee might seek lower rates of growth in money and credit.

On a more general level still, Chairman Burns continued, one way of conceiving the Committee's mission would be to try to correct for all mistakes that might be made in the private sector of the economy and all policy errors and misjudgments that might be made elsewhere in Government. Another and more modest way of conceiving that mission would be to try to make a reasonable contribution to economic stability and growth without trying to counteract the effects of all mistakes made in the private sphere and elsewhere in Government. The Committee would discuss monetary policy tomorrow morning.

Thereupon the meeting recessed until 9:30 a.m. the following morning, Tuesday, June 20, 1972. The attendance was the same as on Monday afternoon except that Miss Stockwell, Mrs. Junz, and Messrs. Sammons, Zeisel, Ettin, Taylor, Enzler, Peret, Roxon, and Bodner were not present and the following persons were present:

Mr. Coombs, Special Manager, System Open Market Account

Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

Mr. Cooper, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on April 18, 1972, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on April 18, 1972, was accepted.

Chairman Burns noted that David Hexter, who had served the Committee capably as Assistant General Counsel since March 1960, was retiring at the end of this month. He recommended that the Committee elect Thomas J. O'Connell, General Counsel of the Board of Governors, to that post, effective July 1, 1972.

> By unanimous vote, Thomas J. O'Connell was elected Assistant General Counsel of the Federal Open Market Committee, to serve for the period from July 1, 1972, until the date of the first meeting of the Committee after February 28, 1973, with the understanding that in the event of the discontinuance of his official connection with the Board of Governors he would cease to have any official connection with the Federal Open Market Committee.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period May 23 through June 14, 1972, and a supplemental report covering the period June 15 through 19, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that in the period since the last meeting of the Committee the exchange markets had shifted into an increasingly apprehensive mood. Speculation in the London gold market had tended to spill over into the foreign exchanges, and sterling had come under intense selling pressure while most of the continental currencies had strengthened. Throughout most of the period the dollar had shown a fairly high degree of resiliency, but during the past week some signs of weakness had appeared.

The major development, Mr. Coombs reported, had been the explosive burst of speculation against sterling, which had cost the Bank of England nearly $600 million last Thursday and Friday, June 15 and 16. Inflationary wage settlements, bad trade figures, and a growing conviction in the market that the British Government would not make a major effort to defend the present parity, along with other bearish factors, had set the stage for the sudden wave of speculation that developed around noon last Thursday. Sterling had opened in New York at 2.6070, but late in the morning it suddenly plummeted by nearly 50 points. In that new situation, the Bank of England withdrew its earlier objections to System purchases of sterling in the market. The British officials felt that they could use a little help since the Common Market arrangements, under which the British were required to use Common Market currencies for intervention purposes until sterling had fallen to the Smithsonian floor, had run into some technical difficulties; and they felt that some intervention with dollars in New York would be useful as an emergency measure. In response to their suggestion he had undertaken to buy up to £5 million, an operation which was executed at rates slightly over the 2.60 level. The British specifically asked, however, that the System be careful not to push the sterling rate up unduly since that might in turn push the French and Belgian francs up to their Smithsonian ceilings and hence expose France and Belgium to unwanted inflows of dollars. Shortly after one o'clock that afternoon, in the course of further telephone conversations with Bank of England officials, he had received the distinct impression that the Bank did not intend to put up more than a token defense of the 2.60 level; and with their concurrence he had refrained from placing any further orders for sterling in the market.

On Friday morning, Mr. Coombs continued, the sterling rate opened in New York at 2.5840, down more than 1-1/2 cents, and it would have fallen even further in the absence of massive official intervention--over $500 million all told, mainly in the form of French francs, Belgian francs, German marks, and Norwegian krona. By late Friday afternoon in New York, the selling wave had temporarily run its course; the Bank of England did not have to intervene in New York and the System also stayed out of the market. On Monday, June 19, the sterling market returned to a more balanced position with intervention limited to only $50 million in Europe. In New York, however, the rate began to slip back as soon as the European markets closed and he again telephoned the Bank of England to ask whether they wanted any help in the form of System purchases of sterling. They agreed to his suggestion of trying to buy about

£5 million, but they again cautioned him against operating so strongly as to push up the whole range of European currencies, an outcome which would probably elicit protests from the French and Belgians. Today sterling was again being sold heavily in Europe; the rate at present was down to $2.5830. The cost of intervention was already over $200 million, for a total of more than $800 million since last Thursday noon.

Mr. Coombs remarked that in the absence of some decisive defensive measures by the British Government, such as price and wage controls or a sharp jump in the Bank Rate, it was likely that there would be a further intensification of the selling pressure on sterling that had begun last week. If such selling pressure continued, the Common Market monetary agreement would be subjected to a major test. As the Committee members knew, the Common Market agreement specified a maximum 2-1/4 per cent spread between the member currencies. The recent weakening of the sterling rate had widened the spread between sterling on the one hand and the French franc, Belgian franc, German mark, and Norwegian krona on the other hand to the full 2-1/4 per cent permissible; and the spread had been kept from widening still further only by the Common Market swap credits--now more than $800 million equivalent of marks, francs, and krona--to buy up the surplus of sterling being thrown on the market. Under the terms of the Common Market agreement, by the end of next month those swap credits would have to be paid off by the

British, presumably largely with dollars, or converted into new 3-month swap credits. He suspected that whichever route was taken there would be a fair amount of attendant publicity.

Meanwhile, Mr. Coombs observed, both Britain and its European creditors no doubt were facing the old, familiar dilemma of whether to throw in additional credits in order to defend the sterling parity or to retreat to what might or might not be a more tenable level. In addition, German marks, French francs, and Belgian francs sold by the Bank of England and other central banks in order to mop up sterling seemed so far to have found willing holders in the market and were not being converted into dollars. The French franc, the mark, and other European currencies had come down from their ceilings, but the fact that $800 million of those currencies had been suddenly thrown on the market without causing more than a slight dip in the rates suggested that some demand for them was simultaneously being generated. As a result, something of a tug of war could be developing, with the stronger European currencies restraining the tendency of sterling to decline to still lower levels. If, for example, sterling were now to fall to its Smithsonian floor, it would be about 3 cents below its present level. However, if sterling did fall to its floor it would put the German mark and the French and Belgian francs at par, at which point those currencies might seem fairly attractive to a lot of people.

Thus, Mr. Coombs noted, there was a risk, which had long since been foreseen, that the 2-1/4 per cent Common Market band within the 4-1/2 per cent Smithsonian band could prove destabilizing by generating simultaneous speculation on both the strong and the weak currencies in the bloc. It had seemed to him that there was a basic inconsistency between the 4-1/2 per cent Smithsonian band and the 2-1/4 per cent Common Market band, and that in the end one or the other might have to go. In addition to those speculative pressures, creditor countries in the Common Market, by virtue of the new monetary arrangement, were being forced to expand their money supply for the benefit of foreign speculators. That was hardly to the liking of some of the central banks concerned and it could raise new questions about the functioning of the agreement. Unfortunately, the dollar did not seem to be benefiting so far from the difficulties emerging in Europe, and it could be damaged if a massive shift of dollars from the United Kingdom to the continental countries should begin to raise new doubts in the market--such as those in the first quarter of the year--about the continued willingness of the continental central banks to buy dollars at the Smithsonian ceilings. In general, the situation was highly fluid and there could be some fast-breaking developments within the coming week.

Mr. Coombs reported that in operations during the period the System had paid off $300 million of its swap debt in Swiss francs through a combination of $50 million of market purchases and a $250 million direct transaction with the Swiss National Bank. The System had also paid down $20 million on its Belgian franc debt and $15 million on the sterling debt, for an over-all total of $335 million. That had reduced the debt still outstanding to $2,520 million. He would not be surprised if there were ample opportunity in the next week or so to liquidate the entire $700 million still owed to the Bank of England, which would reduce the System's swap debt to $1.8 billion.

In conclusion, Mr. Coombs said he would like to report to the Committee on discussions with officials of the German Federal Bank regarding the renewal of the swap line, which had reached the end of its 6-month term on June 15. As expected, the Germans took the position that new understandings should be reached regarding the precise meaning of the revaluation clause. In particular, they seemed to be worried about the contingency of a joint revaluation of most or all of the Common Market currencies against the dollar. He thought the Germans might be inclined to think of such a joint revaluation as equivalent to a devaluation of the dollar and hence to raise a question as to whether the revaluation clause should apply in such an event. In reply to a routine telex from the Federal Reserve suggesting extension of the swap line for another 6 months, they had suggested the following qualifying clause: "We understand that it is not likely that the two sides will make use of the swap facility. Should they, however, do so, they will in every case decide by common consent whether the present clause concerning a change in parity, or any other clause, will apply." He had asked the Subcommittee consisting of Messrs. Burns, Hayes, and Robertson to review the German suggestion. The Subcommittee had approved its acceptance, and renewal of the swap line was then agreed upon on that basis. He would assume that a similar qualifying clause would have to be attached to renewal of the swap lines with the central banks of France, the Netherlands, and Italy, which fell due around the end of June.

Mr. MacLaury referred to Mr. Coombs' comment that the credits being drawn by the British on the other participants in the Common Market monetary agreement would be paid off largely in dollars. He asked whether that represented a departure from the rules.

Mr. Coombs replied that no departure from the principles of the agreement was involved. Since the form of debt repayment was based on the composition of a country's reserves, it followed that British repayments would be largely in dollars.

Mr. Brimmer asked about the operational implications of the new clause included in the renewal of the swap line with the Germans.

Mr. Coombs replied that in operational terms the new clause meant that before any future drawings on the swap line were made an agreement would have to be reached concerning the circumstances in which the revaluation clause would apply. He suspected that it would be difficult to get an agreement that the clause would be invoked if a group revalued; the more likely agreement was that the clause would apply only if the Germans alone revalued.

> By unanimous vote, the System open market transactions in foreign currencies during the period May 23 through June 19, 1972, were approved, ratified, and confirmed.

Mr. Coombs then noted that 4 System drawings on the National Bank of Belgium, totaling $110 million equivalent, would mature for the fourth, fifth, or sixth time in the period from July 3 to July 28, 1972. He would take whatever actions were feasible, either by purchases of Belgian francs in the market or directly from the National Bank, to clear up those drawings; but in view of the possibility that exchange markets would remain disturbed for some weeks he thought it would be a useful precaution for the Committee to authorize their renewal. Since the Belgian swap line had been in continuous use for more than a year, express action by the Committee was required if the drawings were to be renewed.

> By unanimous vote, renewal for further periods of 3 months of the 4 System drawings on the National Bank of Belgium maturing in the period July 3-28, 1972, was authorized.

Chairman Burns then invited Mr. Daane to report on the meetings of the central bank governors in Basle and of the Group of Ten Deputies in Paris that he had recently attended.

Mr. Daane noted that, in addition to himself, Messrs. Hayes, MacLaury, and Coombs from the System had attended the Basle meeting, which consisted of an abbreviated session on the afternoon of Sunday, June 11. The meeting was devoted to a "tour d'horizon" of developments in individual countries. For the most part the discussion was rather perfunctory; perhaps its most interesting feature was Governor O'Brien's expression of pessimism, which in retrospect confirmed the report Mr. Coombs had just given on the British external position and prospects. It was noteworthy that Mr. O'Brien had said the British money supply was continuing to expand at an annual rate of 20 per cent and that interest rates were trending upward sharply. Outside the meeting itself, concern was expressed about the implications that the increase in the market price of gold might have for the continuance of the two-tier system and for the functioning of the Common Market monetary arrangements, particularly the arrangements having to do with settlements. As Mr. Coombs had just indicated, those arrangements called for debt repayment in a form based on the composition of the country's reserves; yet the disparity between the market and official price resulted in the so-called immobility of gold. Also, the U.S. representatives had talked with the Germans about the swap line, with the outcome that Mr. Coombs had already reported.

Mr. Coombs added that the Germans had said they would send a document setting forth the grounds for their position on the swap line. The document had not yet been received.

Mr. Daane then noted that the Group of Ten Deputies had met in Paris for a half day on June 13, solely for the purpose of considering the question of activation or allocations of SDR's in the second basic period. The views expressed were preliminary, and in the words of Chairman Ossola, they did not imply a commitment on anyone's part. As the Committee members would recall, for the first basic allocation the United States had originally proposed a period of 5 years, but a 3-year period had eventually been agreed upon. For the second allocation the consensus seemed to favor a shorter period, with the views of the majority centered around 2 years. Concerning the amount, views ranged from zero through "token" creation to "normal" creation. The initial position of the United States was that "normal" creation was slightly to be preferred but that zero was acceptable. Subsequently, the U.S. position was amended to call for zero creation in the first year and $3 billion in the second. The French position was quite interesting; they favored creation of $1 billion or $2 billion over the second allocation period, but for political rather than economic reasons.

Two additional aspects of SDR creation were discussed by the Deputies, Mr. Daane continued. The first involved the question of whether an aid link should be attached to any new creation of SDR's. The second was a proposal, obviously aimed at the United States, that industrial countries agree to use at least a portion of their allocations to redeem their own currencies held in foreign official balances. Neither proposal received any support.

Mr. Mayo asked whether the amounts of SDR's proposed by the French would be considered "token" or "normal."

Mr. Daane replied that those terms obviously could be defined in various ways. He thought most observers would define "normal" as at least $3 billion per year--the amount involved in the first basic allocation--and considering the growth in needs, some would define it as still more. An amount of $1 billion or $2 billion over a 2-year period would not be far from tokenism.

In reply to a question by Mr. Coldwell, Mr. Daane said there was very little support at the G-10 meeting for any change in the allocation formula from that used in the first basic period.

Chairman Burns then asked Mr. Solomon to report on developments at the meeting of Working Party Three of the OECD, which had been held in Paris immediately following the G-10 meeting.

Mr. Solomon noted that Working Party Three had examined an interrelated set of projections for the balance of payments of the major countries over the next year, taking account of the developing cyclical situation in the various countries as well as the effects of the realignment of exchange rates. The exchange of views had brought forth the same uncertainties that were revealed in yesterday's discussion of Mr. Hersey's part of the staff presentation. There were three uncertainties: 1) the extent to which there was a worsening trend in the underlying U.S. trade balance, possibly reflected in the high level of imports recently and matched by an improving trend for Japan, Germany, and other countries; 2) the extent to which the major trade partners of the United States would have expanding economies over the next year and how much that would benefit the U.S. trade balance; and 3) the time pattern of the improvement in the U.S. trade balance as a result of the exchange rate realignment.

There were no major differences over the ultimate effects of the realignment, Mr. Solomon observed. What was uncertain was the timing of the improvement in the U.S. position and the base from which it should be measured. It was as if one were trying to estimate how high a mountain climber would go without knowing the depth of the valley from which he started--and without knowing how fast he climbed. In any case, the attempt by WP-3 to view the entire group of countries on a consistent basis yielded results for the United States that were in the same ballpark as Mr. Hersey's projection.

Mr. Solomon added that the discussion of monetary developments in the major countries brought out that long-term interest rates had turned up recently in some European countries, notably Britain, Germany, and Belgium. That could reflect a more favorable prospect for economic expansion as well as expectations of continued inflation. Short-term interest rates had probably hit bottom in Europe. Whether they would rise any more rapidly than short-term rates here would be a major question over the months ahead.

Mr. Brimmer noted that some feeling of pessimism about the balance of payments outlook had been expressed in yesterday's discussion because the latest projections were considerably less favorable than those made late last year. He asked whether the earlier projections had been based in part on an assumption that the 10 per cent surcharge on imports which had been imposed in August would be continued for longer than it in fact was. If so, the sense of pessimism in yesterday's discussion might not have been wholly warranted.

Chairman Burns remarked that the earlier projection which he, at least, had had in mind in yesterday's discussion had been developed after the Smithsonian meeting, and according to his recollection it took appropriate account of the termination of the import surcharge.

The Chairman then noted that information had been received this morning about highly provisional Commerce Department estimates of second-quarter GNP. He asked Mr. Partee to summarize the differences between those estimates and the Board staff's second-quarter projections that had been presented yesterday.

Mr. Partee observed that the estimates made by the Commerce Department at this stage of the quarter were, of course, based on only partial data. Accordingly, they were never published, and they were made available with[illegible]vernment on a confidential basis. The Commerce estimates showed an increase in total dollar GNP during the quarter of $28 billion, or about $1 billion less than the Board projection. However, there were larger differences in the changes shown for the components. In particular, in the Commerce estimates final sales rose somewhat more and the change in business inventories--while still positive--was smaller than in the Board projections. As far as he knew, the Department's inventory figure was based on complete data only through April plus some limited information for May. He might also note that the Commerce estimate of net exports in the quarter was about $1-1/2 billion weaker than the Board's figure. That difference, he believed, was simply a consequence of differences in expectations for merchandise trade in May and June; the Board's staff had allowed for some improvement in those months, while Commerce probably had not.

Perhaps the most outstanding difference, Mr. Partee continued, related to the rise shown for real GNP in the second quarter, which was about 8 per cent in the Commerce figures and 6-1/2 per cent in the Board's. An 8 per cent growth rate would not be inconsistent with available information on industrial production and manhours, so there was a reasonable chance that the Commerce figure would prove to be the more nearly accurate. Associated with the difference in GNP estimates was a difference in the estimated rise in the implicit GNP deflator. As the members would recall, in the first quarter the deflator had increased at a rate of 6 per cent, partly reflecting the effects of the Federal military and civilian pay raise, and the Board staff had projected that the deflator would increase at a 4 per cent rate in the second quarter. As estimated by the Commerce Department, however, the rise was only 2.2 per cent, well below the recent rate of advance in most price indexes. The lowness of the Commerce figure might reflect the effects of changes in weights and other special factors. In part, however, it might reflect an expectation of a rather small increase in the consumer price index for May. It appeared likely to many observers that the May increase in the CPI would not be large, partly because the marked advance in prices of foods--particularly meats--in that month had occurred too late to be reflected in the index.

In response to a question by Chairman Burns, Mr. Partee said the May CPI probably would be released tomorrow. He doubted that the Commerce Department had had advance information on its specific level for use in preparing the second-quarter GNP estimates, but it was likely that they had a general impression of the probable magnitude of change.

The Chairman then observed that if any Committee members had been under the illusion following yesterday's discussion that they knew where the economy was likely to be at the end of 1973, they were reminded by Mr. Partee's summary of the differences in the two sets of estimates for the second quarter that there was considerable doubt regarding the current position of the economy.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period May 23 through June 14, 1972, and a supplemental report covering the period June 15 through 19, 1972. Copies of both reports have been placed in the files of the Committee.

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

> During the period since the Committee last met the monetary and credit aggregates tended to grow a bit more slowly than had been anticipated at the time of the last meeting. Reserves against private deposits (RPD) over most of the period rose at a rate somewhat below the midpoint of the 7-1/2 to 11-1/2 per cent range adopted by the Committee. It now appears, if preliminary estimates of deposits for the week ended June 14 are confirmed, that RPD for May and June combined may turn out a shade below the lower end of that range. The slowing in the growth rates of the aggregates was achieved with less pressure in the money market than had been anticipated at the time of the last meeting. Thus, although reserves were supplied in a fashion that edged the Federal funds rate up close to 4-1/2 per cent--about 1/4 of a percentage point higher than had prevailed earlier--a generally steady tone prevailed in the money market.

Despite the modest firming of money market conditions, the capital markets improved early in the period as new issue activity was light and there was a large supply of funds seeking investment. However, investor resistance to lower yields resulting from aggressive pricing of new issues by underwriters tended to push prices lower in the latter part of the period, and on balance long-term interest rates were little changed over the period as a whole. There was some backing and filling in the market for Treasury coupon issues as participants speculated about the possibility that the Treasury might undertake an advance refunding during the period it would not be in the market to raise new money. Price changes were modest, however, and trading activity was light.

Rates on Treasury bills moved lower early in the period as the Treasury's cash position remained strong, and dealers anticipated that debt redemption in June would create a demand for bills. In the past few days, however, rates moved higher, partly because of the policy implications attributed by the market to sales of bills by the Treasury out of the supply acquired from Germany earlier this year and by the System. In yesterday's regular auction of Treasury bills average rates of about 3.92 and 4.33 per cent were established for 3- and 6-month bills, respectively, each up about 10 basis points from rates established in the auction just prior to the last meeting of the Committee. Generally, the market is expecting a further rise in short-term rates, as the result of a strong upsurge of the economy and of an increased supply of bills once the Treasury returns to the market.

The Treasury is still debating whether or not to proceed with an advance refunding and a decision should be forthcoming at any moment, since an announcement should be made by tomorrow in order to get the operation out of the way before the July 4 weekend. The market is not exactly enthusiastic about the prospects of an advance refunding, but it appears likely that some useful debt extension might be achieved if the Treasury reaches an affirmative decision. The technical position of the market is quite strong with dealers running net short positions in Treasury notes and bonds.

In following the RPD target, Desk intervention in the market was infrequent. Repurchase agreements were made on two occasions ; $175 million Federal agency securities were purchased on June 2 ; there were a number of bill transactions with foreign accounts; and $137 million Treasury bills were sold in a market go-around last

> week. As noted earlier, RPD growth for much of the period appeared to be running in the lower half of the range adopted by the Committee, and that--given the desired slowing of the monetary aggregates--appeared to be satisfactory. Preliminary data received late last week now indicate a growth rate for RPD of about 7 per cent for May-June combined, a bit below the lower end of the 7.5 to 11.5 per cent range. With the estimate still tentative and an ample supply of reserves available in the current week, no effort was made to change the Desk's approach to reserve supply pending further instructions at this meeting.
>
> Looking ahead, there is an apparent need to supply a substantial volume of reserves in coming weeks. There is a possibility that the first weekend in July could be difficult, since the Government securities market may be closed on July 3. With the Friday before the weekend falling on June 30, the money market may not be a very good guide to reserve availability since banks tend to sit on the sidelines on a statement date. While there could be some temporary aberration in reserves and money market conditions, I anticipate no major problem.

Mr. Daane referred to the Manager's comments about the possibility of an advance refunding. He asked what impact such an operation might have on market yields and how much response the Treasury could expect from those eligible to participate.

Mr. Holmes replied that while such matters were difficult to predict he thought the Treasury probably could achieve some debt extension without having a major impact on yields. He would not expect much market speculation in the refunding. Dealers were not likely to be anxious to participate--although if the Treasury were to offer, say, a 7-year note they might be tempted to cover part of their present short position in longer-term securities. Among other types of participants, medium-sized and small banks might be attracted to the operation.

Mr. Daane then asked whether an advance refunding would require the Committee to maintain an even keel posture.

Mr. Holmes said he thought such an operation would place some constraint on monetary policy, but not a long-lasting one. If, for example, the Committee decided to move toward somewhat greater restraint it might be necessary to temper open market operations for a short period, while the refunding was under way.

Mr. Brimmer said he had recently read news reports about the growth of a futures market in Federal funds. He asked whether that development could produce problems for System open market operations.

Mr. Holmes commented that a number of commercial banks which had been regular sellers of Federal funds had recently begun to make loans to other banks payable in Federal funds for periods ranging from 2 days to 2 or 3 months, or even longer. Although such transactions were described in the market as "futures trading" in Federal funds, or sales of "term Federal funds," they were simply interbank loans. Their volume was not particularly large at present and they posed no problem for open market operations.

Mr. Holmes added that the New York Bank was making a study of transactions of the kind under discussion. About the only problem that had been turned up so far was that of proper reporting; some banks apparently were reporting the transactions as Federal funds operations, despite the fact that the latter were defined as transactions limited to one business day; and some might be reporting them as interbank deposits. Properly, the lender should report the transaction under "loans to domestic banks," and the borrower under "liabilities for borrowed money."

Chairman Burns remarked that one news story referring to futures trading in Federal funds also reported that System bill sales on Friday had frightened other investors out of the market. He asked whether that report was accurate.

Mr. Holmes replied that the story in question was based on a misinterpretation of developments. On Thursday the Treasury had sold some bills which the Exchange Stabilization Fund had acquired earlier from Germany, and on Friday the System had made some routine sales of bills to absorb redundant reserves. Like ome other observers, the author of the story in question had interpreted those operations as having a policy significance that was not intended.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 23 through June 19, 1972, were approved, ratified, and confirmed.

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

The recent calm behavior of credit markets and monetary aggregates does not seem to suggest difficult strategic problems for monetary policy in the early summer period. On the other hand, the longer-run outlook provided as part of yesterday's discussion does point to a rising interest rate trend, with consequent questions as to the sustainability of the existing structure of official interest rates, such as the discount rate and Regulation Q ceilings. But the time horizon for problems with official interest rate levels almost certainly is beyond the interval between now and the mid-July meeting and might even be delayed until the fall or early winter.

There is, of course, room for short-term rates to rise before official rates come seriously into question, and there will be a substantial exposure to a fairly sharp upward movement in short-term interest rates sometime in the summer. The 3-month bill rate is still about 1/2 percentage point below a 4-1/2 per cent Federal funds rate. That yield spread can easily be erased--and under some circumstances reversed--once the Treasury resumes net cash borrowing in the third quarter.

In the second quarter, the Treasury has repaid $6 billion of debt on balance--about seasonal dimensions or a little better. But back in early April, market participants would have thought that there would have been sizable contra-seasonal cash borrowing in the spring. The sharp change in market expectations since then helps explain the virtual stability since early April in Treasury bill and private short-term market rates in the face of a 30-35 basis point rise in the Federal funds rate.

In the forthcoming quarter we would expect Treasury net cash borrowing of about $8-$9 billion. Some such borrowing will have to be undertaken in July--by mid-July as we see the numbers, and by late July or early August as the Treasury sees them. As that prospective borrowing comes into view, the very recent upward movement of bill rates is likely to be extended further. And such an upward movement would probably spread to other short-term markets, assuming that business loan demands on banks remain strong and that there is at least some increased use of the commercial paper market by nonfinancial businesses. Resulting upward rate pressures in Treasury bill and private short-term markets are likely to have feed-back upward effects on the Federal funds rate.

Thus, looking back for a minute, the Federal funds rate has been low relative to staff expectations over the past three months; it would appear that one factor keeping the funds rate down has been the absence of credit demands, in the bill market particularly. This has kept the cost of CD funds to banks down, making it less urgent for banks to bid for Federal funds, and has at the same time made Federal funds a more attractive investment compared to short bills for banks with surplus funds. By the same reasoning, as short-term markets generally tighten in the coming months, it seems likely that the Federal funds rate will move up relative to reserve paths to a level more in line with earlier expectations.

I do not mean to sound excessively dogged about this. And you can see from the blue book[1/] that we have lowered the bottom end of the Federal funds rate range for any given amount of monetary and reserve expansion in recognition of the past less-than-anticipated net demand pressures on the funds market. Moreover, one cannot be sure of the size and timing of Treasury financings. But what I am trying to do is to give some forewarning of upward short-term rate pressures to come without prejudging whether they will manifest themselves strongly in the weeks immediately ahead or not until later in the summer.

To focus specifically on the next few weeks, we think that some further upward pressure on the funds rate seems likely to develop under either alternatives B or C presented in the blue book, with perhaps some downward pressure under A.[2/] The alternative B pattern is closest to the pattern adopted by the Committee at its last meeting, in which a reserve path was set that was expected to work toward a 6-1/2 per cent M_1 growth rate in the third quarter and to a slowing of expansion in M_2 and bank credit in that quarter relative to the second.

Should upward pressures on the funds rate emerge from the reserve strategy adopted by the Committee at this meeting, there are reasonable odds that this will cause some disquiet in long-term markets, particularly

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

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

if the Treasury were to undertake an advance refunding in the period immediately ahead before its regular mid-August refunding. But in view of the rather moderate volume of corporate bond offerings we anticipate for July, I would expect any upward movement in long-term rates to be fairly modest. Thus, capital market developments generally will probably not be a significant factor in the Committee's ability to adhere to a reserve path.

If the Treasury is also in the market, this will, of course, require special mention in the directive. But it is by now quite well known by the market that the Committee is placing greater emphasis on monetary aggregates and reserves. In this context, both the Treasury and other market participants should be expecting less strict adherence to even keel in operations than at some times in the past. And it seems to me that on economic grounds, including an ability to maintain control of the aggregates, the Committee needs to avoid being unduly constrained by even-keel considerations.

If the Treasury were to announce an advance refunding either tonight or tomorrow night, even a liberal interpretation of even keel would preclude any significant change in money market conditions between then and about a week later when books would be closed on the refunding. However, I would suggest that thereafter there could be some freedom for the funds rate to move up or down if necessary as the Account Manager adheres to the reserve path adopted. This freedom might be somewhat more limited than would be the case if the Treasury had not been in the market--at least more limited until around the July 10 settlement date. But a movement of the funds rate on the up-side, if required, to about 4-3/4 per cent, does not seem unreasonable to me, even at the risk of some little adverse reaction on prices of Treasury notes and bonds.

Whether a Treasury refunding will in fact conflict seriously with adherence to a reserve path cannot really be predicted in advance, and if the conflict were to become sharp enough, it would clearly require consultation by the Manager. But it seems to me important to establish the principle of more flexible operations under even keel. If this does not become an issue in the weeks immediately ahead, it is certainly likely to become one later in the summer and in the fall when a sizable Treasury cash deficit has to be financed.

Mr. Daane noted that the staff had proposed the deletion from the directive of the instruction to take account of capital market developments in both alternatives A and B. He was puzzled by that proposal in view of the prospects for upward pressures on interest rates, the possibility of an advance refunding, and the uncertainties in the international area. He was also rather disturbed by Mr. Axilrod's comments on even keel. It was true, of course, that the Committee had been tending to interpret the even-keel constraint more flexibly, and everyone would agree that monetary policy should not be "unduly" constrained by even-keel considerations. At the same time, if the Treasury were to undertake an advance refunding he thought the Committee would not want to interfere with the successful achievement of some worthwhile debt extension.

Mr. Mitchell said he would take strong exception to the implications of Mr. Daane's final remark. An advance refunding designed to achieve substantial debt extension would have a tightening effect on the economy, and if the Treasury decided to take such action now he thought the System should let the Treasury bear the burden of its decision. Also, the fact that the Treasury would be coming to market repeatedly later in the year militated against attempting to offset the effects of an advance refunding at this time.

Mr. Daane replied that he would interpret even keel not as offsetting the effects of the advance refunding but simply as facilitating the operation and, hopefully, keeping the market from overreacting to it.

Mr. Brimmer noted that Deputy Secretary of the Treasury Walker was quoted in today's papers as saying that long-term interest rates might already have reached their peak. For Mr. Walker to express that view at a time when the Treasury was considering an advance refunding could imply that the Treasury expected the Federal Reserve to provide the reserves necessary for the market to absorb the new issues at prevailing interest rates.

Chairman Burns said it was his understanding that if the Treasury decided to proceed with an advance refunding the decision would be based on a judgment that the operation would have a negligible influence on long-term markets. That judgment might, of course, prove to be wrong.

In reply to a question by Mr. Mitchell, Mr. Holmes said the even-keel constraint in itself would not call for preventing any interest rate increases that might result from the advance refunding. He would interpret it simply to call for the avoidance, during a brief period, of any actions that might tend to upset the refunding.

Mr. Mitchell remarked that he would have no objections to even keel, given such an interpretation. He then referred to

Mr. Daane's comments about the proposed deletion of the reference to capital market developments from the directive, and he asked when and for what purpose the reference had been added.

Mr. Holland replied that the reference had been included in the directive since April. It had been added in April because it appeared that firmer money market conditions might be required to achieve the Committee's RPD target, and there was some concern about the possible impact on long-term interest rates.

Mr. Axilrod expressed the view that an instruction to take account of possible Treasury financing would be adequate to deal with such problems as were likely to arise in long-term markets in the coming period. As he had indicated in his statement, adherence to a reserve path such as that shown under alternative B might result in some further upward pressure on the Federal funds rate. It was unlikely that such a development would lead to an acceleration of corporate bond offerings, although it could be associated with some hesitancy in investor bidding for new corporate issues. Any significant problems would more likely take the form of a dumping of Treasury securities by dealers, should there be an advance refunding; and those problems could be dealt with adequately under an instruction to take account of possible Treasury financing. In general, he thought adherence to a reserve path like that shown under alternative B might be associated with some temporary advance in long-term interest rates but not with advances so large or so persistent as to interfere with the Committee's ability to achieve its reserve objectives.

Mr. Daane remarked that no one could be sure how long the current relative calm would continue in capital markets, particularly in light of the prevailing uncertainties in the international financial area. Since he thought an uptrend in long-term interest rates would not be in the best interests of the economy at present, he still would urge the Committee to give careful consideration to retaining the reference to capital market developments in the directive.

Mr. Brimmer said he doubted that an advance refunding at this juncture would be consistent with current monetary policy objectives, and he wondered why the Treasury might consider the operation to be necessary.

Chairman Burns replied that the Treasury probably would not argue that an advance refunding was necessary. However, he thought there were some good arguments in its favor. For one thing, the average maturity of the Federal debt had been declining rapidly. Even from the point of view of the System's open market operations, some debt lengthening would be helpful because it would reduce the frequency with which the Treasury had to come to market. Secondly, Mr. Shultz had only recently become Secretary of the Treasury, and confidence in the administration of any new Secretary would be enhanced if he demonstrated a conservative attitude toward public finance by undertaking a debt-lengthening operation.

Despite those considerations, the Chairman continued, he had advised against an advance refunding at this time, essentially for the reasons Mr. Mitchell had mentioned. If the Treasury nevertheless decided to proceed with the refunding he, for one, would not be prepared to say they had made the wrong decision. And if the refunding led to a sizable run-up in interest rates, he thought it would be a mistake for the System to stand by and do nothing. He personally doubted that the refunding would have much effect on the long-term market--particularly if the new issues were priced closely, as he suspected they would be, rather than generously.

Chairman Burns said he thought Mr. Axilrod was on sound ground in urging the Committee not to permit even-keel considerations to paralyze monetary policy. At the same time, it should not disregard such considerations completely, either now or in the future.

Mr. Mitchell said he would like to revert to a point he had touched on earlier. At the moment the monetary aggregates were growing at rates below the midpoints of the ranges the Committee had decided were acceptable, and one might therefore argue that somewhat more rapid growth would be permissible in connection with the maintenance of even keel. From a longer-run viewpoint, however, it was important to take account of the difficulties in restraining growth in the aggregates that were likely to arise later in the year, when the Treasury would be engaged in frequent financing operations. That consideration argued for erring on the low side of acceptable growth rates in the interim. On the whole, he would concur in the policy prescription suggested by Mr. Axilrod, which he thought was consistent with the adoption of the alternative B specifications today.

Chairman Burns remarked that he did not disagree with Mr. Mitchell's position.

Mr. Francis said he thought there was adequate evidence of a sufficiently robust recovery to preclude the need for additional stimulus from monetary policy at this time. His policy preference for the weeks and months ahead would be an extension of the policy pursued over the past two months. The specifications associated with alternative C were fully acceptable to him, partly because like Mr. Mitchell he thought the monetary aggregates would come under considerable expansionary pressure later in the year as the Treasury undertook to meet its large cash financing needs.

In reply to a question from Chairman Burns, Mr. Francis said he hoped the Committee would be able to resist more rapid expansion in the aggregates when the Treasury became active in the market. Specifically, he hoped that expansion in money might be held over the balance of the year to its recent growth rate of about 5-1/2 to 6 per cent.

Mr. Heflin said he thought the staff's presentation yesterday had been one of the most helpful he had heard. He did not think policy decisions should be based primarily on projections stemming from econometric models, but he believed the staff had done an excellent job of delineating the policy trade-offs and bringing the policy choices into clearer focus. As Chairman Burns had suggested at the close of yesterday's discussion, the staff had given the Committee a good look at the limitations under which monetary policy might well have to labor in the months ahead.

Regardless of how one viewed the economic outlook, Mr. Heflin continued, it was clear that the economy was beset by two persistent problems--unemployment and inflation. It might well be that in its discussions of the past 2 or 3 months the Committee had allowed itself to become unduly influenced by a boom psychology relating more to future prospects than to current developments. While the view down the road could not be overlooked, he did not think any excesses in the economy had become evident to date. In fact, the latest red book[1/] suggested that there were many areas around the country which had not shared in the current upswing in economic activity, including the Baltimore area in the Richmond District.

Under the circumstances, Mr. Heflin observed, he favored what he regarded as the moderate growth rates associated with alternative B, but he would not mind having those growth rates

1/ The report, "Current Economic Comment by District," prepared for the Committee by the staff.

shaded in the direction of the higher rates of alternative A. In particular, he would not like to see a money growth rate of less than 6 per cent and he would not be at all concerned if the rate were slightly higher. In sum, he would be cautious about taking for granted a boom that had not yet firmly materialized.

Mr. Eastburn recalled that monetary policy had often been paralyzed in the past by even-keel considerations, and since the Committee would be confronted by even-keel problems in the months ahead he agreed wholeheartedly with the view that a policy of moderate growth in the aggregates was desirable at this time. An additional reason for such a policy was that good progress had been made recently in curbing the rates of growth in the aggregates from their rapid first-quarter pace. That progress was recognized by market participants, and a renewed upsurge in growth at this time would be likely to cause confusion and concern in the market. He would therefore maintain the present stance of monetary policy, and he thought alternative B would be the appropriate policy choice.

Mr. Mayo said he also supported alternative B. He thought current policy was on the right course, and he would caution against "tinkering" through slight shifts in either direction. Also, he thought Committee members might be giving undue weight to the implications of a possible Treasury advance refunding. In his view such a refunding would have considerably less impact on the market, for any given dollar volume, than would the Treasury cash financings to be undertaken later in the year. For the most part, advance refundings involved switches into longer-term maturities by current holders rather than the distribution of securities to new holders.

Mr. Coldwell said he would favor continuing on a policy course of slow retrenchment in the provision of reserves and minor further reductions in the targets for the monetary aggregates. He would suggest additional flexibility, however, in the implementation of policy in connection with both the RPD growth target and money market conditions. Specifically, he would favor specifications similar to those of alternative B but calling for growth in RPD over the June-July period in a range perhaps as wide as 4 to 9 per cent, and Federal funds in a 4 to 5-1/2 per cent range. In his view the Manager would require flexibility in the period ahead not only in connection with the targets for the aggregates but also in the event the Treasury should undertake an advance refunding. While he shared Mr. Mayo's belief that an advance refunding was not likely to have a great impact on the market, he still felt the Manager would need some leeway to cope with such a financing. As to the directive, he would add references in the operational paragraph to capital market developments and to the international financial situation.

Mr. Treiber said he agreed with Mr. Coldwell that there should be some further modest restraint in the provision of reserves. He thought such a policy would be appropriate in light of the general strength of the economy, the prospects for excessive fiscal stimulation, and the continuation of wage and price inflation. As the blue book and today's discussion suggested, short-term interest rates were likely to rise and that should have a beneficial international impact, particularly in the light of the new strains in foreign exchange markets.

Mr. Treiber found the specifications associated with alternative C in the blue book to be generally satisfactory, except perhaps for the range for the Federal funds rate, which was shown as 4-1/2 to 6 per cent under C. He thought the alternative C targets for the aggregates probably could be achieved with a Federal funds rate in the 4-1/4 to 5-1/2 per cent range which the Committee had found appropriate at its May meeting.

Mr. Robertson observed that in his view the economy was not only expanding rapidly but was verging on a boom. This was a time for caution; inflationary expectations were alive, and as Mr. Mitchell had indicated, it would be difficult for the System to exercise restraint in the second half of the year because of the Treasury's heavy financing schedule. He favored alternative B for the directive but he hoped any errors would be made on the side of firmness. Indeed, aggregate growth rates below those associated with alternative B would be acceptable to him in view of the likely difficulties of controlling the aggregates later in the year. And, while he agreed that a reference to capital market developments should be included in the directive, he would like to see interest rates move up a little.

Mr. Winn noted that in the staff's draft of the first paragraph of the directive a sentence beginning "The U.S. balance of payments has been in surplus in recent weeks...." was followed by a sentence reading "In April the excess of merchandise imports over exports was even larger than in February or March." In view of the opposing thrusts of those two statements, he thought some better transition was needed; perhaps the second sentence could be revised to begin "In April, however,...."

There was general agreement with that suggestion.

Mr. Winn then said he agreed with Mr. Robertson that inflationary expectations were very much alive. In conversations with a number of money managers during the past week he had found them deeply concerned about the prospects for inflation and inclined to pull out of the bond markets completely. In view of the likelihood that rising prices would be receiving widespread publicity this summer, he was pleased that growth in the aggregates had been on the low side of the target over the past month. He hoped that would continue to be the case.

Mr. MacLaury said he would like to add his compliments to the staff for their excellent presentation yesterday afternoon. He particularly appreciated the analysis of the probable effects on unemployment and on prices of monetary policies more and less expansive than that assumed for the central projections. Despite Mr. Daane's criticism of the use of M_1 growth rates for the purpose, he thought it was useful for the Committee to have some indication of the consequences of alternative monetary policies. His only criticism of the staff's analysis related to the use of the over-all unemployment rate in considering the trade-off between unemployment and prices and in measuring the gap between actual and potential output. Use of the over-all rate could be misleading because of changes in the composition of the labor force of the kind that had been discussed yesterday. It would be better, in his judgment, to use the unemployment rate for heads of households.

Chairman Burns agreed that it would be helpful for the Committee to give greater weight than it had been to the unemployment rates of adults and of married men, and not to focus so closely on the over-all rate. As to the method of measuring potential output, he noted that the calculations the staff had presented yesterday were based on the assumption of a 3.8 per cent rate of unemployment. It was desirable for the Committee to have such calculations, since they were widely employed elsewhere. At the same time, it would be useful also to have supplementary calculations based on a more realistic unemployment rate--perhaps 4.5 per cent.

Mr. Partee indicated that the staff would undertake a review of the whole question of measuring potential output.

Mr. MacLaury added that increased attention to questions of composition of the labor force and of the unemployed group would be helpful in reaching judgments about what could be accomplished by means of demand management through monetary policy. As to the current situation, like Mr. Winn he had been pleased to see the aggregates come out on the low side of the target recently, particularly since they had been on the high side for several months previously. He favored maintaining the present stance of policy during the coming month. The alternative B specifications were acceptable to him, except that he would retain the 4-1/4 to 5-1/2 per cent range for the funds rate agreed upon at the last meeting, rather than reduce the lower end to 4 per cent, as suggested under B in the blue book. If the funds rate were actually to fall to 4 per cent, participants in domestic financial markets would be given a misleading signal of the Committee's intentions. The consequences also might be undesirable from the international standpoint, although he would attach less weight to that consideration.

Mr. Morris said he supported alternative B. He was sympathetic to the views expressed by Messrs. Mitchell and Robertson; since it was likely to prove difficult to keep the aggregates under control later in the year, he thought it would be well to err on the low side at this time. As to the possible advance refunding, he shared Mr. Mayo's view that an excessive amount of concern was being expressed today about its potential impact on the market. Under present conditions, with bond markets dominated by inflationary expectations, Treasury action to extend the average maturity of the debt was unlikely to have much of an impact on long-term rates. In his experience there never had been a time when a good economic case could be made for an advance refunding, but the Treasury nevertheless had to engage in such operations on occasion.

Concerning even keel in general, Mr. Morris continued, if the Committee wanted to achieve more freedom of action it might formulate a position with respect to future financings and announce it to the market in order to avoid the uncertainties that arose from inadequate understanding. The position itself might appropriately take the form of a commitment to maintain an even keel posture only during the period in which the books were open in a financing. The Committee could, of course, reserve the right to continue even keel for a longer period whenever it thought that was in the public interest.

Mr. Brimmer said he hoped that in formulating policy the Committee would look beyond the month of July to the whole third quarter and preferably to the rest of the year. With that sort of time horizon in mind, he thought that the policy agreed upon in May was appropriate and should be continued and that adoption of alternative B would achieve that objective. In light of the gathering strength of the economy, however, he would prefer that any errors made in the pursuit of the alternative B growth rates for the aggregates be in the direction of the slower alternative C rates. In his view, there was no need to reduce the lower end of the range for the funds rate from 4-1/4 to 4 per cent; as Mr. MacLaury had observed, a decline in the funds rate to 4 per cent would provide a misleading signal to the market. He thought it would be appropriate to include a reference to capital market developments in the directive.

Mr. Brimmer noted that he had commented earlier on the possible advance refunding. While he would be willing to give the Manager additional flexibility in the event of a refunding, he would not want interest rates to be held at their present levels. In his judgment, if the Treasury decided to undertake a debt-lengthening operation at this time it should pay the price in the form of higher interest rates. He assumed the rate impact would not be excessive, but he thought it should be permitted to show through.

Mr. Kimbrel said he was pleased that monetary growth had slowed in the last 2 months. The economy appeared to be strong, and he, like Mr. Winn, had been hearing frequent comments about inflationary expectations. He hoped that the rate of growth in M_1 could be held to 6 per cent or less, and he would not be greatly disturbed if short-term interest rates edged up slightly. Like Mr. Mitchell, he was prepared to see monetary growth falter at this time in order to provide more latitude for growth later in the year. He preferred the specifications of alternative C.

Mr. Daane said he also had found yesterday's staff presentation to be excellent. In criticizing the use of M_1 as an allegedly precise indicator of policy--a criticism which he should perhaps have directed as much at the Committee as at the staff--he was reflecting his concern about the widespread view that growth rates in M_1 offered the only significant measure of policy, even in the very short run. He had repeatedly encountered such a view abroad. He would reiterate his hope that the System would take pains to avoid reinforcing it.

Concerning current policy, Mr. Daane agreed with those who considered the present stance to be about right. He favored alternative B, except that he would add an instruction to take account of capital market developments. He could accept Mr. MacLaury's position with respect to the Federal funds rate. Also, some uptick in short-term rates might be helpful from the international point of view.

As he had indicated earlier, Mr. Daane continued, he thought even keel considerations should be given appropriate weight if the Treasury undertook a sizable advance refunding. He shared the view of Messrs. Mayo and Morris that the market impact of such an operation would not be great. While he would want to give the Manager the necessary flexibility to deal with a refunding, he certainly would not favor paralyzing monetary policy. Finally, he was not prepared at this point to accept Mr. Morris' suggestion that an even keel should ordinarily be maintained only while the books were open in a financing. While he thought that suggestion should be studied, he was inclined to retain flexibility and avoid rigid formulas.

Chairman Burns noted that most Committee members had expressed a preference for alternative B of the draft directives. Some suggestions had been made with regard to the language of the operational paragraph, including a suggestion for inclusion of an instruction to take account of developments in capital markets. He asked the members to indicate whether they favored such a modification of the draft, and a majority responded affirmatively.

Chairman Burns then observed that the addition of a reference to international developments had also been suggested.

Mr. Daane remarked that it would be helpful to have the views of the staff on that suggestion.

Mr. Coombs said he had no opinion with regard to the desirability of including a reference to international developments in the directive itself, but he would note that there might well be some serious disturbances in foreign exchange markets over the next 2 or 3 weeks. As he had indicated earlier, sterling had already required some $800 million in support operations, and it was quite possible that substantially larger amounts of dollars would come out of London in the weeks immediately ahead. The question was where those dollars would go; if a large portion moved into marks, French francs, and other continental currencies, there could be a recurrence of the speculation that had emerged in the first quarter.

In response to a question by Chairman Burns regarding the implications of such a development, Mr. Coombs said that large speculative flows could have a major impact on the standing of the dollar and would raise new questions about the viability of the Smithsonian Agreement.

Chairman Burns said it was not clear to him at the moment how the U.S. money market might respond in that eventuality or what operations the Desk would be expected to undertake. If there were untoward developments in the foreign exchange markets of a kind that raised questions about the Committee's policy directive--

as there might well be--the Committee members could review the situation and decide whether supplementary instructions were necessary. In short, he would be inclined to remain alert to actual developments rather than to provide the Manager with some vague instruction at this time.

Mr. Mitchell agreed. He added that the inclusion of a reference to international developments in the directive could prove puzzling to readers of the policy record when it was published in 90 days unless the Committee had some specific interpretation in mind at this point.

In response to a question by Chairman Burns, Mr. Holmes said he did not think the addition of the proposed reference in today's directive would be particularly helpful as a guide to operations. If a large flow of dollars to Europe were to develop, the Committee might find it desirable to issue supplementary instructions relating to Treasury bill rates. However, it probably would be better to make such a policy decision in the light of the specific circumstances prevailing rather than to try to anticipate various eventualities today.

In response to a question by Mr. Daane, Mr. Holland remarked that the Committee had dealt with similar problems in two ways in the past. At times when large-scale flows of dollars were expected to put undesired upward or downward pressure on Treasury bill rates, the Committee had included a reference to international developments in the operational paragraph of the directive. At other times, when the Committee was alert to particular foreign exchange market conditions but did not view them as having immediate implications for domestic open market operations, it had included a statement regarding those conditions in the first paragraph of the directive.

Mr. Brimmer said that since a reference to foreign exchange markets apparently would not have any operational significance, he would prefer to omit it from the directive entirely. It would, of course, be desirable to include a statement about foreign exchange developments in the policy record for today's meeting, since they were among the considerations the Committee had taken into account.

Mr. Daane said he thought it would be desirable to refer to recent exchange market developments in the first paragraph of the directive. Mr. Mitchell agreed.

After further discussion, it was decided to add the following sentence at the end of the first paragraph of the directive: "Some strains have developed in international financial markets recently, involving European currencies."

Mr. Coldwell then proposed that the word "modest" be substituted for "moderate" in describing the desired growth in the monetary aggregates in order to indicate that the Committee was seeking to curb growth in the aggregates somewhat further.

After discussion it was decided not to make that change.

The Committee then turned to a discussion of the desired range for the Federal funds rate. Mr. Treiber noted that he and some other speakers had expressed a preference for retaining the 4-1/4 per cent lower limit adopted at the May meeting rather than reducing the lower limit to 4 per cent as suggested under alternative B.

Mr. Mitchell said he thought it was highly unlikely that the aggregates would be so weak in the period ahead as to call for a reduction in the funds rate to 4 per cent. If they were that weak, however, he thought the Desk should be authorized to let the funds rate move down.

Chairman Burns agreed. He added that for several successive months the staff had failed to estimate correctly the relationship between the Federal funds rate and the rates of growth in reserves and monetary aggregates. It was because of the possibility of another such error that the staff had suggested some widening of the funds rate range associated with the various policy alternatives, including alternative B. A decision to set the lower limit of the range at 4 per cent did not mean the Manager was being instructed to achieve such a funds rate; rather, it meant that if the aggregates were growing at rates below those desired by the Committee, the Manager was not to resist a decline in the funds rate indefinitely. He would also note that if the lower limit for the funds rate were set at 4-1/4 per cent, the Manager would have leeway on the upside but virtually none on the downside. The adoption of a 4-1/4 per cent lower limit would be inconsistent with the terms of the experiment on which the Committee had embarked in February, because primary emphasis would no longer be on the growth rate of reserves but would once again be on the Federal funds rate.

Mr. Daane said that as a general matter he would like to see a wider acceptable range for changes in the Federal funds rate, just as he would like to see less attention paid to short-run variations in the growth rates of the monetary aggregates. He asked how rigidly the Manager interpreted the ranges the Committee specified for the funds rate.

In reply, Mr. Holmes said it was his understanding that the funds rate constraint was to be interpreted in terms of weekly average levels rather than day-to-day figures. He also understood that the Committee would want the Desk to move the funds rate toward the upper or lower end of the specified range only if the rates of growth of the aggregates were significantly above or below those desired.

The Chairman observed that his understandings were the same as Mr. Holmes'. In his judgment the Desk should be congratulated on its general performance. The Committee had been concerned about excessive rates of growth in the aggregates earlier in the year, but that situation had now been rectified. On the whole, he thought matters were in excellent shape at present.

Mr. Brimmer recalled that he had spoken earlier against the proposal to reduce the lower end of the range for the Federal funds rate. His objective was to reduce the risk of excessive growth in the monetary aggregates, and he thought the chances of achieving that objective would be better if the 4-1/4 to 5-1/2 per cent range adopted at the May meeting were retained. Reducing the lower end of the range to 4 per cent would represent an innovation that he would consider undesirable.

Chairman Burns said he did not agree that a reduction in the lower limit for the funds rate would be an innovation. Indeed, he felt the undesirable innovation had occurred at the previous meeting, when the Committee had set the lower limit for the funds rate virtually at the level then prevailing in the market rather than specifying a more or less symmetrical range around the prevailing rate.

Mr. MacLaury said he would place a somewhat different interpretation on the Committee's decision at the May meeting to set a 4-1/4 per cent lower limit for the Federal funds rate. Many members, including himself, had expressed a desire to see the aggregates grow at rates toward the lower end of their projected ranges. While that decision might have represented at least a partial modification of the current experiment, it was motivated by the members' wishes with regard to the direction in which any errors should occur. For much the same reason, he would favor setting a

4-1/4 per cent floor on the funds rate today; in light of the prospects noted by several members for more rapid growth in the aggregates later this year, he would not be at all disturbed if a shortfall were to occur in the period immediately ahead. As he had indicated earlier, however, he would be concerned about the risk of giving a wrong signal to the market by permitting the funds rate to decline.

Mr. Mitchell remarked that exceptionally low growth rates in the aggregates also could provide a misleading signal to the market. In his judgment, market participants were tending increasingly to look to the aggregates, rather than to the funds rate, for clues to the stance of monetary policy.

In reply to a question by Mr. Daane, Mr. Holmes said it was his impression that market participants still gave a good deal of weight to the Federal funds rate. That was partly because data on the aggregates were available only with a considerable lag, whereas the funds rate could be observed continuously during each business day.

The Chairman then suggested that the Committee resolve the issue of the range to be specified for the Federal funds rate. In response to his questions, a majority of members indicated that they would find acceptable either a 4 or 4-1/4 per cent lower limit for the range, but more members expressed a preference for the former than for the latter.

Mr. Coldwell noted that the B specifications included a 6-1/2 per cent target growth rate for RPD in June-July. He asked whether it would not be desirable to employ a range for RPD as well as for the funds rate.

Chairman Burns suggested that the Committee interpret its target for RPD in terms of a range 2 percentage points on either side of the central value, consistent with its practice at other recent meetings. That would mean a target range of 4-1/2 to 8-1/2 per cent for RPD in the June-July period. He then proposed that the Committee vote on a directive consisting of the three general paragraphs drafted by the staff, with the modifications in the first paragraph that had been agreed upon earlier, and alternative B for the operational paragraph, with the addition of a reference to developments in capital markets. It would be understood that in implementing the directive the Manager would be guided by the specifications shown under alternative B in the blue book, within the five-point procedure the Committee had been following since the meeting of February 15, 1972.

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

The information reviewed at this meeting, including recent data for such measures of business activity as industrial production, employment, and retail sales, suggests that real output of goods and services is growing at a faster rate in the current quarter than in the two preceding quarters, but the unemployment rate remains high. In May wholesale prices of farm and food products advanced appreciably--after having changed little in April--and the rise in prices of industrial commodities remained substantial. The most recent data suggest some moderation in the pace of advance in wage rates. The U.S. balance of payments has been in surplus in recent weeks on both the official settlements basis and the net liquidity basis. In April, however, the excess of merchandise imports over exports was even larger than in February and March. Some strains have developed in international financial markets recently, involving European currencies.

Growth in the narrowly defined money stock slowed further in May, while growth in the broadly defined money stock stepped up somewhat as inflows of consumer-type time and savings deposits to banks expanded considerably; over the April-May period, growth in both measures of the money stock was well below the high rates in the first quarter of the year. The outstanding volume of large-denomination CD's increased substantially further in May, and expansion in the bank credit proxy remained rapid. In recent weeks, market interest rates have continued to fluctuate in a narrow range.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of possible Treasury financing and developments in capital markets, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

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

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, July 18, 1972, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

CONFIDENTIAL (FR) June 19, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 20, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting, including recent data for such measures of business activity as industrial production, employment, and retail sales, suggests that real output of goods and services is growing at a faster rate in the current quarter than in the two preceding quarters, but the unemployment rate remains high. In May wholesale prices of farm and food products advanced appreciably--after having changed little in April--and the rise in prices of industrial commodities remained substantial. The most recent data suggest some moderation in the pace of advance in wage rates. The U.S. balance of payments has been in surplus in recent weeks on both the official settlements basis and the net liquidity basis. In April the excess of merchandise imports over exports was even larger than in February and March.

Growth in the narrowly defined money stock slowed further in May, while growth in the broadly defined money stock stepped up somewhat as inflows of consumer-type time and savings deposits to banks expanded considerably; over the April-May period, growth in both measures of the money stock was well below the high rates in the first quarter of the year. The outstanding volume of large-denomination CD's increased substantially further in May, and expansion in the bank credit proxy remained rapid. In recent weeks, market interest rates have continued to fluctuate in a narrow range.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of possible Treasury financing, the Committee seeks to achieve bank reserve and money market conditions that will support growth in monetary aggregates over the months ahead at somewhat faster rates than in recent months.

Alternative B

To implement this policy, while taking account of possible Treasury financing, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of capital market developments and possible Treasury financing, the Committee seeks to achieve bank reserve and money market conditions that will support growth in monetary aggregates over the months ahead at somewhat slower rates than in recent months.

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

June 20, 1972

Points for FOMC Guidance to Manager in Implementation of Directive (As agreed upon 2/15/72)	SPECIFICATIONS (As agreed, 6/20/72)
1. Desired rate of growth in aggregate reserves expressed as a range rather than a point target.	4.5-8.5% seas. adj. annual rate in RPD in June-July
2. Range of toleration for fluctuations in Federal funds rate--enough to allow significant changes in reserve supply, but not so much as to disturb markets.	4-5.5%
3. Federal funds rate to be moved in an orderly way within the range of tolerance (rather than to be allowed to bounce around unchecked between the upper and lower limit of the range).	
4. Significant deviations from expectations for monetary aggregates (M_1, M_2, and bank credit) are to be given some allowance by the Manager as he supplies reserves between meetings.	see table below
5. If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.	

(SAAR)

	June	July	2nd Q	3rd Q
M_1:	6.0	9.0	6.0	6.5
M_2:	10.5	9.5	9.0	7.5
Proxy:	4.0	3.5	10.5	7.0