MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, July 18, 1972, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Bucher
Mr. Coldwell
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Robertson
Mr. Sheehan
Mr. Winn

Messrs. 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. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. O'Connell, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Bryant, Gramley, Green, Hersey, and Hocter, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors
Messrs. Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors

Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Messrs. Kiley and Ring, Associate Director and Assistant Director, respectively, Division of Federal Reserve Bank Operations, Board of Governors[1]
Mr. Struble, Economist, Division of Research and Statistics, Board of Governors
Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

Messrs. Leonard and Merritt, First Vice Presidents, Federal Reserve Banks of St. Louis and San Francisco, respectively
Messrs. Parthemos, Taylor, Scheld, Tow, and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond, Atlanta, Chicago, Kansas City, and San Francisco, respectively
Mr. Garvy, Economic Adviser, Federal Reserve Bank of New York
Mr. Jordan, Vice President, Federal Reserve Bank of St. Louis
Mr. Fieleke, Assistant Vice President and Economist, Federal Reserve Bank of Boston
Mr. Kaminow, Research Officer and Economist, Federal Reserve Bank of Philadelphia
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis
Mr. Sandberg, Manager, Acceptance and Securities Departments, Federal Reserve Bank of New York

By unanimous vote, the action of members of the Federal Open Market Committee on July 6, 1972, amending the operational paragraph of the current economic policy directive issued on June 20, 1972, by the addition of a reference to international developments was ratified.[2]

1/ Entered meeting at point indicated.
2/ With this amendment, the operational paragraph read as follows:

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

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on May 23, 1972, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on May 23, 1972, was accepted.

Chairman Burns invited Mr. Daane to report on developments at the July Basle meeting which he and Mr. Sheehan had attended.

Mr. Daane remarked that the Basle meeting held on Sunday, July 9, had been quite interesting and worthwhile. The Sunday afternoon discussion had involved a "tour d'horizon" in which the interest had centered on the United Kingdom, Germany, and Japan. Governor O'Brien reviewed the developments which had led to the floating of the pound. He cited the country's poor record since 1971 in the fight against inflation, the success of the labor unions in obtaining large wage settlements, the threat of a dock strike, Chancellor Barber's announcement of a highly expansionary budget, and Shadow-Chancellor Healey's prediction that the pound would have to be devalued during the summer. In the same connection, Governor O'Brien referred to the very rapid expansion of the U.K. money supply--which had been growing at a rate of around 20 per cent. He also took special note of the effort to maintain sterling within the narrow margin of the so-called "snake in the tunnel."

Mr. Daane observed that in his assessment of the economic outlook Governor O'Brien had been rather pessimistic about the

prospects for containing inflation. He noted that the United Kingdom was still relying on voluntary controls. The Confederation of British Industry had indicated that it would support the Government's efforts for another few months in the hope that the labor unions would also be induced to cooperate, but Governor O'Brien was not very hopeful about the attitude of the unions. He foresaw a possible need to move to mandatory controls, which would require enabling legislation. In response to his (Mr. Daane's) question, Governor O'Brien indicated that he hoped there would be an early return to a fixed exchange rate for sterling, but he implied that that event might well have to be delayed. In that connection Dr. Stopper, President of the Swiss National Bank, had made a rather significant comment; he described as shocking and dangerous the fact that speculators could force the pound to be floated despite the basics of the situation which, in his judgment, in no way called for a devaluation of sterling. Dr. Stopper had also commented in detail on the new foreign exchange controls imposed by the Swiss. Dr. Carli of the Bank of Italy was a bit less gloomy about the prospects for the Italian economy and he indicated that for the first time he saw some concrete evidence of an upturn in economic activity.

Mr. Daane added that President Klasen of the German Federal Bank had given a detailed review of the events leading up to the

adoption of various foreign exchange controls in Germany. He noted that the members of the German cabinet, with the exception of Dr. Schiller, and officials of the Federal Bank all felt the moment had come to take measures which would prove Germany's determination to adhere to the Smithsonian agreement. It was Mr. Daane's impression from the review that Dr. Klasen and the Federal Bank would be very much at the center of events in Germany between now and the country's elections late this year.

Governor Sasaki of the Bank of Japan had reviewed developments in his country, Mr. Daane continued. The Governor stated flatly that the Japanese economy had reached a turning point and business activity was now in an uptrend. He also cited statistics showing that the rate of increase in Japanese exports was declining while the rate of increase in imports was accelerating. He concluded that the Japanese trade account was moving toward better balance, although the surplus was still very large.

Mr. Daane added that throughout the discussion two questions kept recurring. One was whether the United States could do anything to help stem the speculative movement of dollars or, as some governors put it, to help lessen the waves of speculation now that other major countries had erected dams on their side. They offered no specific suggestions, but simply asked what, if anything, the United States could do to signal its determination to cooperate in protecting the

Smithsonian agreement. The second question was more pointed; it was whether the United States could design and offer attractive investment outlets for the excess dollar accumulations of foreign central banks. In that connection, the governors were thinking of countries outside the Group of Ten as well as their own countries. He had responded that the kind of arrangements the U.S. Treasury had made with Germany were certainly open for discussion with other nations. Beyond that, he noted that some consideration had been given last year to the possibility of issuing special Treasury instruments or using money-employed accounts at the Federal Reserve Bank of New York, and he had indicated a willingness to take a fresh look at those possibilities.

Chairman Burns noted that the July Basle meeting was the first Mr. Sheehan had attended. He invited him to supplement Mr. Daane's observations and also to give his general impressions of the Basle setting as a forum for monetary discussions.

Mr. Sheehan said he had nothing to add to Mr. Daane's summary of the meeting. As to the Basle setting in general, he had been favorably impressed by the warm personal relationships that characterized the meeting. He had been surprised, for example, by the openness of one governor in commenting on the internal debates within his government stemming from the recent unsettlement in the foreign exchange markets. That was but one illustration of the atmosphere

of mutual trust and confidence which had deeply impressed him at the meeting.

Mr. Sheehan added that the System had a most valuable resource in Mr. Daane because of the esteem in which he was held and because of the willingness of other governors to talk with him with perfect frankness about problems of mutual concern to their countries and the United States. The close relationships which Mr. Daane had established were something that could not be developed overnight.

Mr. Sheehan said he had also formed the impression that the Basle meetings would be much less useful if the United States were not a participant. That view was buttressed by a conversation he had had with one governor. The latter observed that over the past 25 years the United States had made a contribution of almost incalculable value to the development of the world economy, as a result of its ability and willingness to exercise international leadership and to support the Bretton Woods agreement. At the present time, the governor continued, a leadership vacuum existed and none of the other major countries was in a position to assume the earlier role of the United States. He ended with a passionate plea, which he (Mr. Sheehan) thought made a good deal of sense, for the United States to come forward once again to lead in the reestablishment of order in the world financial system.

Mr. Robertson asked whether Messrs. Daane, Sheehan, and Coombs had heard any conversations in Basle on the subject of dollar loans to multinational corporations by central banks, and the latter replied in the negative.

Mr. Robertson said he had been told that the Bank of Japan had begun to make such loans and that there were indications other central banks might follow.

Chairman Burns observed that the Japanese were both lending and borrowing dollars. They were following the seemingly inconsistent policy of trying to moderate their dollar accruals through export-import intervention, while seeking to finance in the United States such major purchases as airplanes and nuclear power plants.

Mr. Brimmer noted that a representative of the Bank of Japan who had visited the Board recently had addressed himself to the question of Japan's policy with regard to the management of its dollar balances. The visitor had indicated that the Bank of Japan was anxious to cut back its dollar lending activities, but it was faced with the problem that other elements in the Japanese government found it difficult to provide alternative financing to Japanese corporations. Another consideration was that those corporations were obviously anxious to secure financing on the most attractive terms, and in that respect the 6 per cent rate of the Export-Import Bank served as a magnet. Finally, the Japanese were somewhat

hampered by their own legislation. Although they were working on that problem, there was little hope of significant results in the near future.

Chairman Burns then asked Mr. Hayes to report on his recent visits at a number of central banks in Europe.

Mr. Hayes indicated that he had visited central banks in Lisbon, Madrid, Rome, Paris, and London, and he had also attended the June meeting in Basle. His reception at all of the banks had been most cordial, as usual. In his conversations in Portugal and Spain he had noted with particular interest that their dollar reserves were heavily concentrated in the Euro-dollar market--a fact that served to emphasize the significance of Mr. Daane's earlier comments regarding a possible vehicle for investing foreign dollar accumulations in the United States. Officials at some European central banks had expressed a willingness to invest dollars in this country if a relatively attractive return could be earned.

Mr. Hayes said the situation in France presented a classic illustration of conflict between the internal and the external objectives of monetary policy. The French were experiencing domestic inflation, but they had learned that whenever they moved

to tighten monetary policy to deal with inflation, the resulting rise in domestic interest rates served to attract inflows of funds. The French authorities would then back off from the tight policy stance without really resolving the policy dilemma.

Mr. Hayes noted that by coincidence he had arrived in London three or four days before the pound was floated. He had observed with fascination how quickly the decision to float had materialized. Even two or three days before the float, there seemed to be virtually no indications of impending crisis. The situation was marked by a great deal of unease, however, and he would add to the list of adverse factors enumerated by Mr. Daane a widespread feeling that a devaluation of sterling was inevitable. Many people felt, for example, that devaluation of the pound would be a condition for Britain's entry into the Common Market. The only other observation he wanted to convey about Great Britian was the apparently great pessimism regarding the outlook for inflation. A good many people appeared to be convinced that the presently ineffective voluntary controls on prices and wages would have to be replaced by mandatory controls.

Mr. Hayes found that inflation was rampant in all five of the countries he had visited despite wide differences in the degree of business optimism about the outlook for economic activity. The cost of living in those countries was increasing at rates ranging from about 6 per cent in France to 12 per cent in Portugal. In some

of the countries only a half-hearted effort was being made to cope with inflation, either because the authorities were afraid of checking real economic growth or because of external considerations. His conversations had also uncovered the feeling of unease noted at the recent Basle meeting regarding the position of the dollar and the absence of leadership by the United States. He had detected a strong desire for some kind of action by this country to further a near-term solution of the present international monetary problems.

Chairman Burns said that in the interest of conserving time today he would distribute a written report on his recent trip to Latin America. However, in order to dispel some of the gloom stemming from the reports of Messrs. Daane and Hayes, he might say a few words about one of the countries he had visited, namely Brazil. That country was experiencing extraordinary economic growth and its rate of inflation, although still high, had been reduced very materially. Monetary adjustments had been made in such a fashion that the distortions and inequities that usually accompanied inflation were to a large degree absent. The aggressive businessmen of the country, and some from abroad, had been given their head, and they were developing the country with amazing speed and success. Confidence in the business community was extraordinarily high. Businessmen were enjoying a stable government; they found expanding

markets; and they felt they knew how to deal with their inflation--in part by reducing it, and in part by accommodating themselves to it.

The Chairman noted that the Brazilians had developed ingenious schemes for stimulating activity in backward areas, through tax policies and other measures. The authorities had also freed the economy from many compulsory restrictions, including a system of guaranteed employment, and in the process they had improved the lot of the working people as well as that of the business community. He felt that Brazil was indeed a land of opportunity for an energetic young man dissatisfied with conditions in his own country.

Chairman Burns then asked Mr. Solomon to report on recent international developments. Mr. Solomon made the following statement:

> One way to review international developments of recent weeks is to ask why exchange markets have been so severely strained since the announcement of the sterling float.
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> In the preceding 3 months--that is, from mid-March to mid-June--foreign exchange markets were calm. Short-term capital was flowing back to the United States and our balance of payments showed a surplus of about $1/2 billion on the official settlements basis. But since the announcement of the sterling float on June 23, the major foreign central banks have added almost $6 billion to their reserves.
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> Why did the sterling float have such a major effect?

One possibility is that market participants believe that the devaluation of sterling will erode some of the competitive advantage that the United States gained from the Smithsonian realignment. While a sterling devaluation will arithmetically reduce the extent of the dollar devaluation of last December, the fact is that the British current account surplus has already been reduced substantially; and British prices and costs are rising much faster than elsewhere. A moderate devaluation of sterling would simply prevent an excessive reduction in Britain's current account position without eating into the competitive gains that the United States can reasonably expect from the Smithsonian agreement.

A second possible explanation for market behavior is that the market is reacting to the U.S. trade figures. Our trade balance has been in heavy deficit, averaging $7 billion at an annual rate in the first 5 months of this year. This is a much larger deficit than was expected for 1972 at the time the Smithsonian realignment was being negotiated. Although there is no reason to reduce our estimate of the swing in our trade balance that will ultimately result from the realignment, it is possible that the underlying trade position is worse than we realized and that we underestimated the magnitude of the improvement in the U.S. trade balance that was needed.

Another possible explanation for the reaction of markets to the sterling float may lie in the alacrity with which other governments closed markets and imposed controls following the announcement that sterling would float. It is true that foreign central banks took in more than $1 billion in the first hour on Friday June 23, after the announcement about sterling had been made. But the Swiss did not even open their market that day nor for several days thereafter, and the other central banks closed their markets quickly and announced a variety of controls before and after reopening. This may well have been taken by markets as a signal that the European central banks are not prepared to absorb dollars in sizable quantity in order to preserve the Smithsonian exchange rates. According to this view, the policy reaction of European monetary authorities to the sterling float had the perverse effect of helping to generate the large inflows that have occurred.

A fourth possibility is that the apparent passivity of the United States in the face of grave international uncertainties may be contributing to the market's expectation of either a further appreciation of other currencies, or further controls, or both.

There may be some validity to each of these explanations for the run on the dollar in recent weeks. One cannot claim that market participants were completely irrational in their view of sterling a month ago and in their view of the other Smithsonian exchange rates since then. Given the fact that the U.S. basic deficit will remain large for some time, we have to face the possibility that exchange markets will continue to be disturbed in the months ahead. Among the events that could affect the markets are the U.S. monthly trade figures, the domestic debate on the budget, and the unfolding data on the wage-price performance of the United States.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period June 20 through July 12, 1972, and a supplemental report covering the period July 13 through 17, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the recovery of the dollar on the exchange markets during the spring months had suffered a severe setback as a result of the recent sterling crisis. Over the past month the central banks of Germany, France, the Netherlands, Belgium, Switzerland, and Japan had been forced to take in more than $6 billion, and

some of them would have to take in an additional $2 billion or so at the end of this month when the British settled their Common Market debt. Of the $2.5 billion which the British had lost while they were still defending the previous parity, very little had come to the United States; most of the money was absorbed by the Common Market countries.

At the moment, Mr. Coombs observed, the dollar remained at or close to the floor against the mark, the French franc, the guilder, the Swiss franc, the Belgian franc, and the yen, despite the introduction of further severe controls against capital inflows by several of the countries concerned. Moreover, the mark and Swiss franc were currently quoted at premiums of around 5 per cent in the forward market, after having moved up yesterday and again this morning. The present situation pointed up the underlying problem of confidence and provided still another painful illustration of the tendency of floating rates to breed more speculation and to lead to more restrictions rather than to facilitate their removal.

The sterling crisis had also revealed some serious technical deficiencies in the Common Market "snake in the tunnel," Mr. Coombs continued. At the Committee's last meeting he had suggested that there was a basic inconsistency between the 2-1/4 per cent Common Market band and the 4-1/2 per cent Smithsonian band, and that the

combination of those two bands would tend to be destabilizing by generating simultaneous speculation on the strong and the weak currencies in the Common Market bloc. In effect, as sterling came under pressure in mid-June, it was prevented from falling to its Smithsonian floor by the inherent strength of the continental currencies; the latter were, nevertheless, artificially depressed below their Smithsonian ceilings--by more than 1 per cent in some cases--as they were thrown on the market to help defend sterling. That situation provided a virtual shooting gallery for the speculators and must have greatly intensified the selling pressure on sterling.

Mr. Coombs said the breakdown of the "snake in the tunnel" experiment had not only forced the British and the Danes to pull out of the experiment but had also induced the Italians to resume defending the lira by selling dollars rather than other European currencies. In effect, the Bank of Italy had decided to run down its dollar reserves, if necessary, rather than incur debts in other Common Market currencies, which would then have to be settled in part by paying out gold and SDR's. Finally, the technical deficiencies of the "snake in the tunnel" had aroused widespread speculation that the Common Market countries might now seek a more drastic solution by shifting to a joint float against the dollar. Speculation on a joint float had been the major immediate

reason for the inflows of more than $3 billion to the continental central banks during the past four days. In general, banks and corporate treasurers all over the world were now persuaded that financial cooperation among the major countries was rapidly disintegrating. In that atmosphere, the exchange markets were beginning to resemble a casino with the odds rigged in favor of the players rather than the house.

Mr. Coombs added that the only morsel of good news he had to pass on today was that the System was finally making progress in paying off its sterling swap debt. The members would recall that at the May 23 meeting he had reported that the Treasury had suggested that the System make a quick deal with the Bank of England to clean up the sterling debt, but he had felt that in view of the troubled outlook for sterling the System would do well to stretch the repayment schedule to the next maturity in mid-August in order to take advantage of a probable decline in the sterling rate. The Committee had agreed that the problem should be referred to a subcommittee consisting of the Chairman and the Vice Chairman of the Committee and the Vice Chairman of the Board of Governors, or designated alternates.

At the end of June, Mr. Coombs continued, he had made a specific proposal to the subcommittee that the System should now proceed over the next 6 weeks to make daily purchases of sterling,

either in the market or directly from the Bank of England, at a pace sufficient to cover the System's short position by mid-August. Meanwhile, the Treasury shifted its view following the sterling float and began to urge the System to support the sterling rate by market purchases even though the Bank of England's policy had generally favored letting sterling find its own level on the down side. Last week the subcommittee approved a sterling purchase program, including not only direct transactions with the Bank of England but also market purchases, insofar as a reconciliation of Treasury and Bank of England policy views could be secured. Starting on Thursday July 13, the New York Bank had bought a total of £14 million directly from the Bank of England and £4.5 million in the market, and had paid down its sterling debt from $663 million to $618 million. Of the $618 million still needed, he hoped to be able to buy $245 million from Treasury holdings late this month, and he thought the System should be able to acquire the residual $373 million, either in the market or by direct deals with the Bank of England. Under that repayment schedule, assuming the sterling was acquired at an average rate near the present 2.44, the System would save nearly $50 million relative to the cost that would have been incurred if the whole swap debt had been paid off in May, when sterling was at 2.61.

Mr. Eastburn asked whether an increase in Federal Reserve discount rates would have a helpful effect in the international area or whether it would be interpreted as evidencing undue concern on the part of the Federal Reserve.

Mr. Coombs replied that a higher level of domestic interest rates would obviously exert a stronger pull on short-term funds from abroad. However, as he diagnosed the present situation, it reflected primarily a crisis of confidence. The latest surge of speculation had erupted without advance warning in exchange markets that had been relatively peaceful before mid-June. In his view, the current wave of speculation had been generated by deficiencies within the present international monetary system. One of the major deficiencies, which had been referred to earlier today, was the absence of U.S. leadership and the resulting feeling in the exchange markets that anything could happen.

In reply to a further question, Mr. Coombs said he understood that the increase in the British Bank Rate on June 22 had been made primarily for domestic rather than international reasons. The increase was intended to bring the Bank Rate into better alignment with domestic interest rates, which had been rising in previous weeks.

By unanimous vote, the System open market transactions in foreign currencies during the period June 20 through July 17, 1972, were approved, ratified, and confirmed.

Mr. Coombs then reported that 8 System drawings on the National Bank of Belgium, totaling $325 million, would mature for the fourth, fifth, or sixth times in the period from August 4 to August 25. He thought it possible, but not likely, that large outflows from Belgium would permit the System to repay the drawings as they matured, but in the absence of such outflows he saw no practicable alternative to renewing the drawings. He anticipated no objections to the renewals from the National Bank of Belgium. Since the Belgian swap line had been in continuous use for more than one year, specific Committee approval of the renewals was required under the terms of paragraph 1D of the foreign currency authorization.

> By unanimous vote, renewal for further periods of 3 months of the 8 System drawings on the National Bank of Belgium maturing in the period August 4-25, 1972, was approved.

Mr. Coombs said he would also recommend renewal of 2 drawings on the Swiss National Bank, totaling $700 million, which would mature for the fourth time on August 10 and 17. Again, he thought it was unlikely that large outflows from Switzerland would permit System repayment of the drawings by the maturity dates, and he would anticipate no objections to their renewal by the other party. Specific Committee approval also was required for those renewals, as well as for renewal of certain other drawings

he would mention subsequently, since they would lead to continuous use of the swap lines in question for a period of more than one year.

> By unanimous vote, renewal for further periods of 3 months of the 2 System drawings on the Swiss National Bank maturing on August 10 and 17, 1972, was approved.

Mr. Coombs then recommended renewal of 2 swap drawings on the Bank for International Settlements which would mature for the fourth time during August. They were a $600 million drawing in Swiss francs maturing on August 11 and a $35 million drawing in Belgian francs maturing on August 18.

> By unanimous vote, renewal for further periods of 3 months of the System drawings of Swiss and Belgian francs on the Bank for International Settlements maturing on August 11 and August 18, 1972, respectively, was approved.

Mr. Coombs observed that the swap drawing on the Bank of England, currently totaling $618 million, would come up for a fourth renewal on August 17 unless it was paid off by the maturity date. As he had indicated earlier, the program of sterling purchases now under way would probably permit the complete repayment of the drawing by August 17. Nevertheless, to guard against unforeseen developments, he would recommend that the Committee approve renewal of any amounts up to $618 million remaining unpaid at the maturity date.

By unanimous vote, renewal for a further period of 3 months of the System drawing on the Bank of England maturing on August 17, 1972, was approved.

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

Mr. Partee made the following statement:

The economic data received over the past month have shown less vigor than earlier in the spring. Thus, despite a drop in unemployment concentrated in the younger age groups, nonfarm payroll employment failed to increase in June and the number of factory jobs declined for the first time this year. The industrial production index rose only 0.3 per cent last month, and the May figure was revised down to a 0.3 per cent increase also. Retail sales dropped back 1-1/2 per cent in June, according to the advance report, and new car deliveries continued comparatively weak in early July. Many of the red book[1/] summaries also note instances of slower growth recently in District indicators.

Despite these signs of moderation, we continue to view the economic outlook as highly favorable. In some instances, the June data may have reflected unusual weather conditions, including extensive flooding in the East. And in any event, short-run aberrations are not uncommon in the course of general economic expansion. Second-quarter data, taken as a whole, are strong in almost every respect. Employment, output, sales, and orders all averaged substantially higher than in the first quarter. Official GNP estimates will not be available until later this week, but there is no reason to believe that growth in real output will not approximate the 8 per cent annual rate reported to you as the preliminary unpublished Commerce estimate 4 weeks ago.

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

As before, our expectations of a substantial continuing expansion in economic activity are based on three main areas of support. First, we anticipate a healthy continuing rise in business capital spending. The latest data, for May, indicate persisting strength in new orders for capital equipment, and the red book is replete with reports of strengthened spending plans or order books or both in this area.

Second, we believe that inventory accumulation will accelerate substantially as businesses position themselves to service rising output and sales. Here too, the data for May indicate a sizable upturn in business inventories at both the manufacturing and trade levels, to a $14 billion rate on a book value basis. Benchmark revisions of back data have raised the ratio of inventories to sales and order backlogs somewhat, however, so that the need for inventory restocking may be less pressing than earlier thought. Accordingly, we have reduced moderately our projections of the likely rate of inventory buildup during the second half of the year.

Third, the strength of our economic projection depends on relatively buoyant consumer demands, supported by substantial increases in spendable incomes. The second-quarter performance is quite encouraging on that score. Consumer spending stepped up sharply, paced by durable goods, and the personal saving rate appears to have dropped back to about 6-1/2 per cent--the lowest rate in 3 years. The saving rate was probably influenced by overwithholding of Federal income taxes, since these served to reduce disposable income, but it also reflected a willingness to go into debt at a record rate. Looking ahead, the increase in social security payments has been delayed until the fourth quarter, which has led us to reduce slightly our estimates of consumption in the current quarter, but then the 20 per cent boost will add more to incomes than we had expected. And in the first half of next year, tax refunds will be providing additional impetus to the rise in disposable incomes. Given the prospect for expanding employment and privately generated income flows also, the probabilities thus seem clearly to favor buoyant consumer markets.

A sharper rise than we had been expecting in consumer prices, of course, could cut into the projection of real consumption. But the main areas in which price behavior has received so much attention lately--meats,

leather, and lumber--have been problems for some time and hopefully have been adequately allowed for in our projections. Indeed, the surprising development of the past month was the smallness of the increase in average hourly earnings for the second month in a row. The data must be regarded as tentative, but they now show a rate of increase from January to June averaging only 4.6 per cent, which is well below the rate of increase in earnings before the freeze and also below our projected increase for the second half of the year. Should wage gains continue on the moderate side, which we are not yet prepared to assume, the push on prices from rising costs would be less than is incorporated in our economic projection.

In sum, the outlook for the domestic economy does not seem to me appreciably altered from that presented to the Committee 4 weeks ago. The business news since then has been on the soft side, but this is very probably a temporary aberration. The size of the increase in social security benefits voted by Congress was a surprise, but the impact in the current fiscal year--compared with prior staff expectations--is largely offset by the delayed effective date and the failure to include other liberalizing benefit changes that were in the original bill. And we now have two consecutive months of unusually slow growth in average wage rates, but the data are preliminary and two months do not make a trend.

Therefore, I can see no domestic reason for altering the prescription for monetary policy presented at the last meeting. Monetary growth, as indexed by a 6 per cent rate of expansion in M_1, would seem consistent with the continued vigorous economic expansion that is needed to improve resource utilization rates, while avoiding validation of any step-up in inflationary pressures. It is also likely to be associated over time with rising interest rates, including some firming in longer-term markets, although this, it appears, is being delayed by the continued absence of Treasury financing demand. Whether the present monetary stance should be altered for international reasons is a major policy matter. But I, for one, would have serious misgivings about risking distortion in our rather finely balanced mix of domestic objectives for an uncertain benefit in terms of international financial flows.

Mr. Hayes said he found himself in general agreement with Mr. Partee's evaluation of the economic outlook. In particular, he agreed that despite the recent moderation in some of the business statistics the prospects for further good recovery remained favorable. He thought the sharp rise in social security benefits would add fuel to the consumer spending boom that seemed to be developing; indeed, the outlook for consumer spending, together with a budget which appeared likely to provide excessive fiscal stimulus, presented a real danger that the current recovery might blossom into a runaway boom next year. Admittedly, the outlook for next year was still highly uncertain, but he thought the risks seemed to lie in the direction of excessive growth in spending.

Mr. Hayes observed that he was also very much concerned about the recent price developments, which seemed to suggest deterioration in the effectiveness of the Phase II controls. Wholesale prices of industrial commodities and consumer prices of nonfood commodities had risen at a rapid pace recently, and the sharp advance in prices of farm products was likely to put upward pressure on food prices in the months ahead. In general, the price picture was gloomy.

In response to a question by Chairman Burns, Mr. Partee indicated that he was more optimistic than Mr. Hayes about the

outlook for prices. He had referred in his statement to the relatively rapid increases in prices of meats, leather, and lumber. If those three product categories were excluded, the rise in the index of wholesale prices of commodities during the first half of the year would be lowered considerably. Each of the three categories involved special circumstances, and in each case actions aimed at reducing price pressures had been taken during the past month. Thus, meat import quotas had been suspended for the remainder of the year, and it had been indicated that actual imports during that period would affect quotas for 1973. In the case of leather, over the weekend the Commerce Department had announced export controls limiting hide exports to the volume of a year ago. To the extent that those controls resulted in windfall profits, they would accrue to the meatpackers rather than to the exporters, and they would tend to reduce the upward pressure on meat prices since the packers were operating under the combined pricing system rules of the Price Commission. With regard to lumber prices, the Cost of Living Council had announced yesterday that it was reinstituting wage-price controls on small lumber manufacturers, wholesalers, and retailers. One of the complicating factors in the lumber situation had been a strike in British Columbia, a major source of U.S. lumber imports. The strike had now been settled, and it was expected that a much

better flow of lumber from British Columbia in the months ahead would help meet the heavy U.S. demands.

Mr. Partee added that food prices would be affected by the recent imposition of controls on certain unprocessed foods at stages after that of first sale, and by a change in the Government purchase programs that would substantially reduce average inventory holdings of meats by the Government. Also, as he had noted in his statement, the available statistics showed a considerable moderation in the rate of wage increases in recent months. While the statistics were almost unbelievably favorable and might well be revised upward, the fact remained that the Pay Board was achieving a good deal of success in rolling back specific wage increases. A dramatic example had come to his attention a few weeks ago; it involved a negotiated agreement calling for a 19 per cent increase in wages for some 30,000 grocery workers, which the Pay Board had rolled back to 6.7 per cent without precipitating a strike. For the present, at least, workers seemed willing to settle for smaller wage increases than was the case in 1970 and 1971.

Mr. Leonard indicated that the St. Louis Bank was in general agreement with the staff projections of nominal GNP. He was concerned, however, by projections of the GNP deflator, which implied that the greatest success in the fight against

inflation would be achieved in the second half of 1972, and that the economy would be faced with the prospect of accelerating inflation in 1973. Moreover, he could not help looking beyond next year to 1974 and 1975, and wondering whether inflation might be even greater in those years. That concern was intensified by his view that the staff projections of real growth might be on the high side, implying even more inflation if nominal GNP grew at the rate projected.

Mr. Leonard said that one basis for his concern about the outlook for inflation was a historical study done at the St. Louis Bank, involving comparsions of the real growth achieved so far in 1972 and projected through 1973 with the experience in the earlier postwar business cycles. Only 2 periods had been found which showed a faster expansion in real terms--the initial quarters of the Korean conflict and the period of the Vietnam buildup. Both were periods of broadly distributed excess capacity, and in both the rapid real growth had been followed by substantial inflation.

At the same time, Mr. Leonard continued, he agreed with the staff projection that the unemployment rate would decline only to 5 per cent by the end of 1973. While he did not want to suggest that 5 per cent was an acceptable level of unemployment, he did not consider monetary policy to be the only realistic means for dealing

with that problem; given the geographic and demographic distribution of unemployment, the solutions had to be found elsewhere. He thought current monetary policy was on the right course and that the praise the System was now receiving in the press for its conduct of policy was well-deserved.

Mr. Heflin said he agreed with Mr. Leonard that current monetary policy was about right and that the accolades in the press were deserved. The Committee had started on its current experiment only a few months ago, but it had made considerable progress with respect to both the formulation of its objectives and the operating procedures it employed. It was important, however, to keep the limitations of monetary policy in mind. To a large extent the inflation that was currently being experienced was of the cost-push variety, and monetary policy could not act to correct that sort of inflation without fostering a level of unemployment that would be unacceptably high in the present political and social climate.

Mr. Heflin noted that the year 1972 was one of turmoil and change. He thought particular care should be exercised in the period between now and the end of the year to avoid any actions that would damage the effectiveness of monetary policy in 1973. He would not change monetary policy unless a clear need could be demonstrated. For example, he did not think the economic

situation called for higher short-term interest rates at this time, and he would not favor an increase in the discount rate.

Mr. Heflin added that while the June decline in the unemployment rate was gratifying, it appeared that the statistics were importantly influenced by the timing with which students entered the labor force in search of summer employment. It would be helpful if Mr. Partee would comment on the June figure, and also on the longer-run outlook for unemployment. He wondered in particular why the staff currently was projecting a decline in unemployment only to 5 per cent by the latter part of 1973, in contrast to earlier economic recoveries when the unemployment rate had dropped sharply over a relatively short period of time.

Mr. Partee indicated that he would not attach too much importance to the reported June decline of 0.4 percentage point in the unemployment rate, mainly because of seasonal adjustment problems. Last year, for example, the initial report of June unemployment indicated a 0.6 percentage point decline from May, but the June figure was subsequently revised upward and in any case unemployment returned to about its May level in subsequent months. As Mr. Heflin had suggested, the June figure was affected by the dates at which students left school, in relation to the survey date. The chances were that the unemployment rate would move up in July from the 5.5 per cent level currently reported for June, although he would not expect the rate to return to the 5.9 per cent level of May.

Mr. Partee then turned to the question of the prospective behavior of unemployment during the current economic recovery compared with its behavior in other cyclical recoveries. He noted that while comparisons with past cycles could be quite helpful in interpreting current developments, there were important differences in the configurations of different cycles. The latest decline in economic activity was unusual in that it had not been as sharply concentrated in the industrial sector as had been the case in previous recessions. Moreover, part of the decline that did occur in the industrial sector was in the defense area and was not likely to be reversed. As a result, there were not the same prospects now of reemploying a large number of blue collar workers who had been temporarily laid off as there had been in earlier cyclical advances.

Mr. Partee added that, according to his recollection, in the recovery phase of other recent cycles the unemployment rate had fallen considerably from its high recession level but it had still remained substantial for some time. In the early 1960's, for example, a number of years passed before the rate fell below 5 per cent. Accordingly, the current recovery was not unique with regard to the difficulty of getting the unemployment rate down to a relatively low level. A 4 per cent rate had, in fact, been rather unusual during the past 20 years. He thought the 5 per cent

rate projected by the staff for the end of 1973 was a reasonable target in the sense that it could be attained through increased economic demands without an undue risk that inflationary pressures would develop in the process. Extensive manpower retraining programs probably would be required to reduce unemployment appreciably below 5 per cent without stimulating inflationary pressures.

Chairman Burns said he could agree with all but one of Mr. Partee's observations. As Mr. Partee had indicated, in the early 1960's the unemployment rate had initially fallen rapidly--from about 7 per cent to about 5-1/2 per cent in the first year of the recovery--even though it had subsequently remained above 5 per cent for an extended period. However, the experience in the current recovery seemed to him to be significantly different. If one excepted the June figure, which was surrounded by a statistical cloud, the unemployment rate had not declined at all in the current recovery from its peak level of around 6 per cent first reached in late 1970.

Mr. Brimmer observed that one explanation for the different behavior of unemployment in the two recoveries could be found in the different rates of growth of real output. In the first year following the recession trough of 1961 real output grew at a rate roughly twice that experienced in the first year of the current economic recovery.

Chairman Burns commented that the failure of the unemployment rate to decline in the present recovery also was attributable to some extent to the abnormally large additions to the labor force that stemmed in part from the reduction in the armed forces. As to the slow growth of real output in the current recovery, the delayed recovery in business fixed investment was a contributing factor.

Mr. Partee added that a major characteristic of earlier cycles was a large swing in inventories. In the current cycle there had been no liquidation of inventories and, until perhaps the last month or two, no large accumulation. Also, the performance of net exports was much weaker in the current recovery than in earlier recoveries.

Mr. Mayo said he subscribed almost completely to the staff's projections, which he thought were soundly based. He noted that the staff had lowered somewhat the projection for inventories, and in line with his comments at the previous meeting, he thought the latest projection was more reasonable. He also indicated that the recent pause in some economic statistics had not been reflected in the Chicago area.

Mr. Mayo added that the economic tide was favorable at this point, and like Mr. Heflin he would not want to make any

significant change in monetary policy at this time with regard either to open market operations or to the discount rate. However, he shared some of Mr. Hayes' misgivings about the outlook for Federal Government expenditures. He was not so much concerned about the position of the Federal budget in the current calendar year as he was about the spending decisions that were likely to be made between now and the elections. Those decisions would almost certainly lead to higher spending in calendar 1973. That outcome was likely, he thought, even on the assumption that the Administration continued its efforts to curb expenditures where-ever possible.

Mr. Eastburn asked about the prospects for the Phase II price and wage controls in the period between now and the elections. Specifically, he wondered whether political considerations were likely to lead to some weakening in the controls.

Chairman Burns said he was confident that, to the extent political considerations influenced the Phase II price controls, they would work in the direction of stiffening those controls. As to the wage controls, he found it difficult to express an opinion one way or the other. He asked if Mr. Partee had any additional comments.

Mr. Partee said he had not detected any tendency to back away from the Phase II controls in the meetings of the Cost of

Living Council he had attended. Most of the recent Phase II decisions had been on the price side, including the three major price actions he had commented on earlier. He had a feeling that if additional problems developed in the months ahead, further actions would be taken to cope with them. On the wage side, he shared the Chairman's uncertainty. Wages had not been the problem area recently, and on the basis of what he had heard the Pay Board was taking a tough stand. It was possible, of course, that the Pay Board would come up against an intractable case and would find its decision followed by a major strike. But until that occurred, he felt the Pay Board would be encouraged by its success and would continue on its present course.

Mr. Winn remarked with regard to the unemployment situation that he was disturbed by reports that colleges were finding it very difficult to place their graduates. The problem was in part structural, with schools of education reporting that large proportions of their graduates--as high as 80 per cent--could not find teaching positions.

Mr. MacLaury observed that some of his colleagues had commented favorably on the recent conduct of monetary policy. While the Committee might be able to rest on its oars temporarily, he had misgivings about the months ahead. The recent period had been an unusually easy one for monetary policy, in that a second-quarter growth rate of less than 6 per cent in M_1 had proved to

be consistent with only minor increases in short-term interest rates at a time when nominal GNP was expanding at a rate of 10 or 11 per cent. That situation was unlikely to persist, and the Committee probably would soon be faced with the need to make some difficult policy choices.

The Chairman remarked that Mr. MacLaury might well be right. However, he personally wanted to enjoy the period--however brief it might prove to be--of relative tranquility and marked achievement which monetary policy had experienced over the past half year in the domestic area. The task of monetary policy had been greatly facilitated by fiscal developments. The Federal deficit in fiscal 1972, which had been estimated at nearly $39 billion in January, would actually prove to be around $22 billion. Perhaps $8 billion or so of that reduction was due to overwithholding of income taxes, but a substantial part was due to a real expansion in revenues and to better control over expenditures than had been anticipated. Looking ahead, he thought the main economic problem would be in the realm of fiscal policy. While he foresaw difficulties for next year, he thought the situation was far from hopeless. In that connection he intended to make the strongest statement he had ever made on fiscal policy when he testified before the Joint Economic Committee next week.

Chairman Burns added that in his view the Phase II wage and price controls were achieving some beneficial results. He also wanted to call attention to an indirect contribution of the Committee on Interest and Dividends which perhaps was being overlooked. In formulating and retaining a guideline limiting increases in dividends to 4 per cent, the Committee on Interest and Dividends had restricted the payout of earnings to stockholders and to some extent had reduced the borrowing needs of businesses and therefore the pressure on interest rates.

Before this meeting there had been distributed to members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period June 20 through July 12, 1972, and a supplemental report covering the period July 13 through 17, 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:

> The period since the Committee last met was enlivened by the debt ceiling cliff-hanger, by a renewed bout of speculation in the foreign exchange markets, and by some erratic swings in market factors affecting reserves.
>
> Over much of the period reserves against private nonbank deposits (RPD's) and the aggregates appeared to be coming out at the lower end of the June-July ranges adopted by the Committee, with the Federal funds rate fluctuating narrowly a bit above 4-1/2 per cent. Last Friday's projections, however, indicated a bulge

in M_1 in the first 2 weeks of July that would bring RPD's and the aggregates into the upper end of their ranges.

Open market operations over the period had to cope with some fairly wild gyrations in reserve availability stemming from the erratic behavior of float and other market factors. In the statement week ending last Wednesday, for example, reserve availability burgeoned as the result of an unexpectedly large bulge in float. In order to stay anywhere near our RPD path, the Desk had to absorb a large volume of reserves on Tuesday and Wednesday, mainly through matched sale-purchase agreements. The $2.4 billion of such agreements outstanding on Wednesday represented a record volume.

Short-term interest rates tended to rise over the period by roughly a quarter of a percentage point, and a number of banks raised the prime rate to 5-1/2 per cent last week. The Treasury bill rate, while higher on balance, was subjected to downward pressure from time to time under the weight of heavy demand from foreign official accounts. In yesterday's weekly Treasury bill auction average rates of 3.95 and 4.46 per cent were established for 3- and 6-month bills, respectively--little changed from the average set in the auction just prior to the June Committee meeting for the 3-month bill and 13 basis points higher for the 6-month bill.

To prevent the full weight of foreign demand from pushing the bill rate significantly lower, the Treasury sold $1.8 billion of Special Certificates of Indebtedness to foreign central banks, and it appears that the Treasury will have to sell more than $2-1/2 billion today and tomorrow. While the System bought bills on balance from foreign official accounts, it sold $630 million to these accounts in the latter part of the period. On July 7, in keeping with the terms of the revised directive, an unwanted reserve impact from such sales was offset by repurchase agreements with nonbank dealers

The Treasury's cash position has, of course, been bolstered by this unexpected influx of foreign money, and it now appears unlikely that the Treasury will have to come to the market to raise cash before September, or even October. This unprecedented absence of the

Treasury from the market during a seasonal period of cash needs has, of course, been an important factor restraining the rise of Treasury bill rates. The Treasury will be announcing next week the terms of its August refunding. With only $2.3 billion of the maturing issues held by the public, it should be a routine operation with only minimal even-keel considerations involved--even if the Treasury includes in the refunding $1.8 billion of 2-1/2 per cent bonds maturing on September 15. Should the Treasury offer one or more options, I would plan to exchange the System's holding of $1.5 billion of the maturing issues into the new issues in proportion to the expected public subscription. Should the Treasury include the September 15 maturity of 2-1/2 per cent Treasury bonds in the exchange, I would plan to exchange the System's holdings of $112 million of that issue.

A cautious atmosphere continued to prevail in the capital markets, with most market participants anticipating a strong economy over the rest of the year. There is considerable concern about the size of the likely fiscal 1973 budget deficit, about recent price behavior, and about the international financial situation. Price movements in the market for Treasury coupon issues were restrained, however, by the strong technical position of that market where dealers have had a large short position in issues of more than one year to maturity. Some short covering has been under way for the past several days and the Treasury market has developed, at least temporarily, a somewhat stronger tone.

I suppose little need be said about the debt ceiling issue which was finally resolved late on June 30. We plan to keep our contingency plans[1/] well dusted off for possible use on October 31 when the legislation will again expire.

In reply to questions by Mr. Daane, Mr. Holmes indicated that it would be very difficult for the Desk to help meet the existing foreign official purchase orders--totaling more than $2-1/2 billion--through sales of bills from the System portfolio. The Desk itself

1/ A description of the contingency plans referred to is appended to this memorandum as Attachment C.

expected to be on the buying side of the market today and tomorrow when the transactions with the foreign central banks would be executed. It would therefore be up to the Treasury to supply the securities; indeed, the Treasury had agreed to sell a little over $1 billion today and a little over $1-1/2 billion tomorrow. The Treasury would be selling a combination of special issues and some bills that had been acquired earlier by the Exchange Stabilization Fund.

In response to a question by Chairman Burns, Mr. Holmes said that the special Treasury issues in question would have a maturity of three months, subject to renewal. Consideration was being given by some central banks to somewhat longer initial maturities, and it was likely that the Treasury would be issuing longer-dated special securities in the near future.

Responding to a further question by Mr. Daane, Mr. Holmes said he found it very hard to explain week-to-week fluctuations in the monetary aggregates, and he could not say whether the recent sharp changes in those aggregates were related to the unanticipated absence of the Treasury from the market. Most of the shortfall in June was the result of very weak statistics in the week of June 28, while most of the bulge in the first half of July occurred in the week of July 12. He thought one would have to wait to see if the preliminary statistics were confirmed by later figures before reaching any firm conclusions.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 20 through July 17, 1972, were approved, ratified, and confirmed.

Mr. Axilrod then made the following statement on the monetary relationships discussed in the blue book:[1/]

Of the alternatives presented in the blue book, alternative B most nearly represents a continuation of the policy course adopted at the last Committee meeting. This course, if the Committee wishes to continue with it, would seem to pose little market problem in the even-keel period coming up since it does not at this point appear to imply the need for any appreciable firming of interest rates.

We believe that the RPD path for that alternative--centering on a 5 per cent July-August growth rate--may be accompanied by some further updrift in the Federal funds rate between now and the next Committee meeting. A little further rise from 4-1/2--4-5/8 to 4-5/8--4-3/4 per cent--if that should prove necessary--has probably been discounted in some part by market participants. Since the last Committee meeting the funds rate has risen only about 1/8 of a percentage point, while rates on commercial paper, bankers' acceptances, prime CD's, and bank prime loans have risen 1/4 to 3/8 of a percentage point.

In recent days, shorter-term Treasury bill rates have come under downward pressure as a result of foreign exchange market developments, as has been noted in documentation for the Committee. It is difficult to foresee very substantial upward pressure on bill rates in the weeks immediately ahead from market forces. In particular, the Treasury's cash position is so ample that, apart from small additions to the weekly bill auctions, it is not likely to raise much if any new cash through announced bill offerings before late summer or early fall. Should the dollar outflow continue, this will place further downward

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

pressure on rates in a bill market which is relatively short on supply in any event. Finally, if the Treasury refunding to be announced July 26 focuses on intermediate- and long-term issues, this too will add to downward bill rate pressures, since some of the holders of maturing securities will prefer to reinvest at short term.

Under these circumstances, and taking account of the directive amendment relating to international developments in the inter-meeting period, some special efforts may be required at least to keep the bill rate from declining significantly further, particularly should foreign demand for bills continue strong. I am assuming that whatever efforts, if any, might be made in relation to the bill rate, they would be within the overriding constraint of maintaining the Committee's objectives as to monetary aggregates and bank reserves. Thus, a special effort toward the bill rate would not involve a deliberate effort to raise the Federal funds rate. Some future rise in the funds rate might develop under alternative B--if the Committee adopts that alternative--but this rise is projected on the basis of, and as a result of following, a reserve path. If the Committee wishes to continue adherence to a reserve path, uncertainties in projecting the relationship between the funds rate and monetary aggregates argue against prejudging what the funds rate will have to be and acting to establish such a rate immediately.

Even at present levels, the Federal funds rate currently is unseasonally high relative to the bill rate and will tend to exert an upward pull on bill rates. Given the prospective supply-demand situation in the bill market, though, additional efforts are likely to be required to provide reserves outside the bill market during reserve-supplying periods or to swap bill sales--either in the market or to foreign accounts--against purchases of coupon or agency issues. However, it should be pointed out that there is only a limited supply of intermediate- and longer-term securities in the market, at least until after the Treasury refunding.

How strong a special effort should be made to affect bill rates, of course, will depend on the Committee's fundamental decision as to how it wishes to weigh domestic and international objectives. In helping the Committee evaluate the relationship of these

objectives to bill rates in terms of near-term operating strategy, I would point out that downward bill rate pressures seem bound to be transitory.

The recent behavior of rates in private short-term markets more accurately reflects the fundamental economic factors at work in a period of actual and prospectively strong demands for money and credit. And the upward movement in private short-term rates is also consistent with the view that foreign central bank demand for U.S. Government securities should be reflected in smaller net demand for other types of securities in the U.S. market--in particular, for the securities that were sold by, or would have been bought by, those placing dollar funds abroad. A drop in the whole short-term rate structure from dollar outflows is likely only if there is a reduction in the demand for dollar cash balances and if the System makes an offsetting effort to maintain the volume of such balances in the face of the decline in demand.

In conclusion I would suggest that, as the Committee holds to its basic posture of providing the reserves needed for appropriate domestic growth in money and credit, there may be some scope for manipulating the pattern of open market operations to affect bill rates for international reasons. But I would not think there is a lot of scope if one is to avoid pushing the Federal funds rate upward in advance of, or irrespective of, reserve objectives.

Mr. MacLaury asked Mr. Axilrod to explain the factors that accounted for the relatively low growth rates in the monetary aggregates shown in the blue book for August, compared with the much higher rates shown for July and September.

In reply, Mr. Axilrod said he might focus on M_1, since the fluctuations for that series accounted for the bulk of the fluctuations in the other aggregates. On the basis of preliminary estimates, it appeared that M_1 had increased by some $5 billion in the first 2 weeks of July. The bulge--which was still subject to

revision--might in part have reflected problems with the seasonal adjustment factors, and it might in part have been the consequence of random developments. The level of M_1 was expected to decline in the second half of July; indeed, some partial data for the current statement week--relating to Reserve City banks--tended to support that expectation. Even so, the average level of M_1 in July would be so high that, as a matter of mathematical necessity, the moderate growth expected from the end of July to the end of August would result in a relatively small increase in the average level of M_1 from July to August. For September, M_1 growth was shown at a 6-1/2 per cent rate under alternative B, the same rate as for the third quarter as a whole.

Mr. Mayo observed that the Committee had shifted from total reserves to RPD's for operating target purposes last February partly because of the large short-run fluctuations in total reserves. According to the blue book, however, under all 3 policy alternatives growth in RPD's would drop to a very low rate in August. He asked whether that was simply a technical consequence of the performance of the monetary aggregates as just outlined by Mr. Axilrod and therefore of limited economic significance.

Mr. Axilrod replied in the affirmative. Given the 2-week lag in reserve requirements, growth in RPD's would be substantial in the second half of July because of the sharply higher demand

deposits of the first half of the month, and it was expected to taper off to a very modest pace in August. With those fluctuations, the pattern for RPD's shown under policy alternative B was thought to be consistent with a 6-1/2 per cent rate of growth in M_1 in the third quarter. His present judgment was that such a pattern was attainable.

Mr. MacLaury noted that a third-quarter growth rate of 7 per cent was shown for M_1 in Table 2, captioned "Monetary Aggregates," at the back of the blue book. He asked whether the difference between that figure and the alternative B figure of 6-1/2 per cent shown earlier in the blue book reflected the distinction between a projection and a target.

Mr. Axilrod replied affirmatively. The 6-1/2 per cent growth rate of alternative B represented a target which was thought likely to be associated with some rise in the Federal funds rate from current levels. The monetary growth rates shown in Table 2 were projections based on an assumption of no change in money market conditions.

Mr. Morris asked Mr. Axilrod whether in his judgment the management of reserve growth would be facilitated if the 2-week lag in reserve requirements were eliminated.

Mr. Axilrod responded that the staff had given that question a good deal of thought. His personal view was that reserve management

by the System might have been marginally easier if the 2-week lag had never been introduced. However, he believed the advantages of returning to the previous system would be relatively small and would have to be weighed against the disadvantages. In the latter connection, he noted that some member banks were reported to have found lagged reserves useful in managing their reserve positions.

Chairman Burns said he would be opposed to making a change in reserve computation procedures at this time. The Committee had embarked upon an experiment involving the close control of reserves and he would not want to take any action that would tend to confuse the character of that experiment. He thought, however, that the matter of lagged reserve requirements should be placed on the Board's agenda for consideration early next year; and, since the issues were complicated, he would ask the staff to prepare a report with pro and con arguments and a recommendation. He intended to approach the whole question with an open mind, and he would want to be persuaded that something was gained by the present 2-week lag.

Mr. Brimmer said it might be desirable to ask the staff to review the question with an eye toward dovetailing any change with the changes in Regulations D and J that would become effective in September and October. He suspected that such simultaneous action would facilitate bank adjustments to the revisions in D and J.

Mr. Partee indicated that the staff could certainly review the question of the 2-week lag in the near future, but he would have misgivings about introducing any change this fall. The revisions in Regulations D and J would result in many complications, including increased difficulties in assessing the significance of current statistics on reserves, and to add a further change at the same time would exacerbate such difficulties.

Chairman Burns noted that the Committee members appeared to be ready to begin their consideration of monetary policy. He invited Mr. Hayes to open the discussion.

Mr. Hayes observed that the present economic and financial setting, together with the imminent even keel period, seemed to call for maintenance of a more or less unchanged monetary stance. He shared the satisfaction expressed by others that it had been possible to achieve slower growth of the aggregates in May and June with only a modest firming of interest rates. He also shared Mr. MacLaury's concern, however, that the true test for monetary policy still lay ahead and that hard choices with regard to controlling the aggregates would have to be made in an atmosphere of rising interest rates. He thought some pickup in the growth of M_1 in July was highly desirable, but he also hoped the staff was right in forecasting that the recent spurt in M_1 would prove to be a temporary aberration.

Mr. Hayes remarked that there were three basically unfavorable elements in the current and prospective economic picture--namely, the likelihood of excessive fiscal stimulus, the price situation, and the situation in international financial markets. Under those circumstances he would not like to see a reversal of the recent moderate firming of money market conditions. The specifications associated with alternative B of the draft directives came close to meeting his policy preference, but he thought the lower end of the range specified for the Federal funds rate should be raised from 4 to 4-1/2 per cent, making the range 4-1/2 to 5-1/2 per cent. He also hoped ways could be found to prevent the bill rate from declining and, if possible, to move it somewhat higher. He would suggest that to the extent feasible needed reserves should be supplied by purchases of Treasury coupon and Federal agency issues and by repurchase agreements.

Mr. Hayes said alternative B was acceptable to him for the operational paragraph of the directive. He would suggest, however, that consideration be given at some point soon to a rewording of the third paragraph, which described the Committee's general policy objectives. The current wording was quite vague and it had not been changed for a long time despite changes in circumstances. It might be useful for some staff group--possibly the Committee's economists and associate economists--to consider how the statement might be made more meaningful and how it might be varied from time to time to reflect new developments.

In conclusion, Mr. Hayes noted that he saw no reason at this time to consider action on the discount rate, although he thought the question could become pressing in the next month or two.

Chairman Burns remarked that, if Mr. Hayes' suggestion with regard to the Federal funds rate were adopted by the Committee, the current discount rate would be called into question rather promptly.

Mr. Hayes said he did not think an increase in the discount rate would necessarily be required under such circumstances. There had been a number of times in the past when a change in the discount rate had lagged several months behind a change in open market policy.

Chairman Burns observed that he would not favor adopting Mr. Hayes' suggestion for the Federal funds rate. Apart from the implications for the discount rate, the proposed higher range would also imply that the Committee was abandoning the experiment it had undertaken in February, under which primary emphasis was placed on reserves for target purposes and the Federal funds rate served only as a constraint. He thought it would be most unfortunate to drop an experiment which thus far had been working quite well.

Mr. Hayes said he had not meant to suggest that the Committee should no longer place primary emphasis on the aggregates, although there might be some difference of view in that he would want to recognize the independent effects--psychological and other--that money market conditions had on developments. His

main point, however, was that the Committee's objectives for the aggregates could probably be achieved without letting the Federal funds rate slip back to 4 per cent, and he hoped such a decline in the rate would not be permitted.

Mr. Coldwell expressed the view that the Committee should continue its effort to posture System policy in a manner that would meet the needs to be faced in coming months, albeit with increasing attention to international financial problems. The rates of growth in the monetary aggregates had been reduced recently, and he would like to see them shaded downward a little further in the months ahead. He was not concerned about the range for the Federal funds rate because rates much lower than estimated by the staff had proved to be consistent with achievement of the Committee's targets for growth in RPD's; the Federal funds rate had been in a range of 4-1/4 to 4-5/8 per cent over the last few months, despite the staff's expectation that rates of 5 per cent or more would be needed to achieve the Committee's objectives.

Mr. Coldwell indicated that he would want the Desk to supply reserves reluctantly over the coming months in working to reduce further the rates of growth in the monetary aggregates. In that connection, he would be concerned if growth in RPD's were maintained at the recent rate of about 8-1/2 per cent. He would also avoid any tendency to provide reserves in anticipation of the market's need for them; he thought the need should be clearly

demonstrated before reserve-supplying operations were undertaken. Also, he was somewhat concerned about the Desk's continued heavy use of RP's, although he understood that the short supply of bills in the market had created some difficulties for operations.

In conclusion, Mr. Coldwell said he was deeply concerned about the outlook in the international area, where he thought a major problem was building up for the United States. He hoped that the Committee would give weight to that problem in making its policy decision today.

Chairman Burns said he might report at this point that serious discussions regarding the international monetary problem were under way. If the plans under consideration were to materialize--he had no way of judging the probable outcome--they would deal effectively with the problem. In his opinion, any effort to contribute to the solution by making marginal adjustments in monetary policy might cause difficulties domestically but would not really touch the international problem. Indeed, to be effective in the international area, monetary policy action would probably have to take some such form as an increase in the discount rate from 4-1/2 to perhaps 7 per cent; minor adjustments in the discount rate or the Federal funds rate--of, say, 1/4 or 1/2 percentage point--would have no measurable impact. In sum, major action could be taken but not through the monetary policy route.

Mr. Leonard said that in view of the concern about the economic outlook which he had expressed earlier, he felt there was some danger of overstimulating the economy. In his judgment a somewhat slower growth in nominal GNP than the staff was projecting would be desirable, and he would therefore argue for somewhat slower growth in M_1 than the 6-1/2 per cent rate shown for the third quarter under alternative B. Growth in M_1 over the past year had been at a rate of about 5 to 5-1/2 per cent, the exact rate depending upon whether or not the demand deposit bulge in early July was taken into account. He would like to see growth continue at about the pace of the past year. On the other hand, growth in the second half at the 6 per cent rate which seemed to be implied by alternative B would, in his view, not only prove to be too stimulative; it also would represent an acceleration from the rate of growth experienced in the past 12 months. Since he saw no reason to accelerate M_1 growth, he would favor alternative C for the directive. He would take that alternative to mean that the Desk would seek to continue the 5 to 5-1/2 per cent trend rate of growth in M_1 over the balance of 1972 and 1973.

Mr. Heflin commented that it was important to recognize the limitations of monetary policy. As he had noted earlier, the domestic economy had been experiencing a persistent inflation problem which was primarily of the cost-push variety, and monetary

policy could not address itself to such an inflation without fostering completely unacceptable increases in unemployment. Also, he would agree with Chairman Burns that a 1/4 or 1/2 percentage point increase in the discount rate or Federal funds rate would have virtually no impact on the international side, but it would have undesirable consequences for the domestic economy.

Mr. Heflin added that monetary policy could make a contribution toward stimulating demand in an economy that was still operating below capacity. While he would not want to ignore the apprehensions Messrs. MacLaury and Hayes had expressed concerning the conditions that might be encountered down the road, he thought the Committee's attention should not be diverted from the more important current problem of underutilized labor and capacity resources. Accordingly, he would not like to see growth in M_1 fall much below 6 per cent under present circumstances. Alternative B seemed to fit his policy preference. In sum, he would maintain a steady posture for monetary policy in the period between now and the next meeting.

Mr. Sheehan said he would heartily endorse Mr. Heflin's views.

Mr. Winn observed that Committee deliberations and staff reports seemed to be focusing more and more on M_1 in terms of appraising and auditing monetary policy. He believed that outside

observers were now concentrating more on M_2, and that that might be a more realistic procedure for the Committee. He asked for a staff view of the consequences that would follow from such a shift.

Mr. Axilrod commented that the Committee would probably raise its sights regarding appropriate growth rates; time deposits other than large-denomination CD's had been rising faster than demand deposits, so that M_2 had been expanding more rapidly than M_1. In addition, M_2 was a little less volatile from month to month than M_1 although it did reflect the inherent volatility of demand deposits. In general, however, the fundamental problem of determining the appropriate growth rate would remain, whether M_1 or M_2 was used for target purposes.

Mr. Winn then said he was becoming disturbed about an apparent recent increase in the volume of loan commitments at banks. He had received the impression from conversations with bankers that many of them were not particularly concerned about the risk of becoming over-committed because they thought they could rely on the System to provide the necessary reserves should loan demand pick up. That situation could result in serious problems.

Chairman Burns remarked that businessmen evidently were recalling the difficulties of getting bank loans in the 1966 and 1969 periods and were trying to protect themselves against a

repetition of that experience by arranging for commitments now. In meeting with bankers in the past he had often cautioned them about the risks of becoming over-committed. He was not sure how effective those admonitions had been, and in any case he had not focused on the subject for the past year or so.

Mr. Robertson remarked that his impression was the same as Mr. Winn's. He thought there were grounds for concern that banks were working themselves into a position similar to that of the later 1960's.

Mr. Kimbrel agreed. He noted that in the course of recent informal conversations with Sixth District bankers he had suggested that they avoid the situation of a few years ago, when they found themselves looking to the System to provide the funds they needed to honor their commitments.

Chairman Burns said it would be highly desirable to establish the facts regarding the recent trends in loan commitment volume and then decide whether a System-wide effort was needed to discourage over-commitments. Noting that the Federal Reserve conducted a quarterly survey of bank loan commitments, he asked Mr. Partee what conclusions might be warranted on the basis of the latest survey and when the results of the next survey would be available.

In reply, Mr. Partee said he did not have at hand the findings of the latest survey, which covered the three-month period

ending April 30. It was his recollection, however, that the figures showed an increase in commitments from the preceding period, but not an exceptionally large one. The results of the next survey, covering the period through July 31, should be available in early September. If the Committee so desired, the staff would plan to submit a report for consideration at the September meeting on the findings of the survey and on the sources of funds that might be available to banks to meet the indicated volume of commitments.

Chairman Burns remarked that such a report would be helpful. He added that the quarterly survey had been subject to criticism from both within the System and elsewhere, and that the members should keep its limitations in mind.

Mr. Partee observed that the basic difficulty with the survey derived from the imprecise nature of the concept of a loan commitment. Because of the problems of arriving at a definition that would be meaningful for all banks, survey respondents were, in effect, told to employ their own definitions.

Mr. Brimmer noted that the survey also suffered from limited coverage; it was confined to 40-odd large banks. Since he had the impression that medium-sized banks were engaging increasingly in the practice of making loan commitments, he wondered whether reports should be sought from such banks also.

The Chairman said it might be best to expand the survey after the quality of the present reports had been improved.

Mr. Partee observed that the staff had found it necessary to invest a good deal of time in personal visits to the large banks now reporting in order to minimize the difficulties posed by the conceptual problem he had mentioned. Medium-sized banks probably would require even more assistance before their reports would be useful. However, the staff would look into the possibilities of expanding the coverage of the survey.

Mr. Kimbrel remarked that no survey was likely to be definitive with respect to the volume of loan commitments outstanding at any one time. That was because many commitments which were considered binding by the parties involved were made orally and never reduced to writing.

Chairman Burns commented that it might be desirable for bankers to be fully informed about the variable investment tax credit which the Board had recommended in connection with the housing study, because such a tax credit could have major implications for their operations. If, for example, a reduction in the tax credit were used to curb investment, it might lead to an increase in the external financing needs of business and create difficulties for banks with a large volume of loan commitments outstanding. Congress was not likely to act on the Board's

recommendation this year, and perhaps would not do so in the following year or two; but he believed that the variable investment tax credit would be adopted eventually because it was clearly needed.

The Chairman then remarked that this brief discussion of the subject of commitments had been useful in alerting everyone present to a potential problem. Insofar as the Reserve Bank Presidents were persuaded by their own observations that commitments were being made at too great a rate, it would be helpful for them to make their views known. However, he thought any concerted effort in that area by the System as a whole should wait until after discussion of the staff report that would be available at the time of the Committee's September meeting.

The discussion of current monetary policy then resumed with comments by Mr. Robertson, who expressed the view that the Committee had no choice at present but to maintain its present course by adopting alternative B. He added that in his judgment the success that had been achieved in domestic monetary policy over the past 6 months was attributable in large measure to good fortune rather than to wisdom; the Committee had been aided by factors not under its control.

Mr. Brimmer said he agreed that alternative B was the appropriate choice today. He went on to note that the blue book presented detailed specifications for the various alternatives

only through the end of the current quarter. In its chart presentation at the June meeting the staff had discussed the outlook for both GNP and developments in the financial area through the end of 1973, and the current green book[1/] updated the GNP projections for that period. However, the staff had reverted to a short time horizon in presenting policy alternatives in the current blue book. It would have been desirable, in his judgment, to reexamine the monetary projections made in June at least through the end of 1972.

Mr. Axilrod observed that the blue book did present a brief textual discussion of probable financial developments in the fourth quarter on the assumption of growth in M_1 at a 6 per cent annual rate, the same assumption as employed in the chart show. In particular, it was noted that upward interest rate pressures were likely to be more pronounced in the fourth quarter, partly because of the substantial rise in Treasury cash borrowing expected then. Limiting detailed specifications to the current quarter was consistent with the staff's past practice for blue books prepared in the first month of a quarter. Customarily, such specifications covering the following quarter were introduced during the middle month of a quarter, when the time period covered was not quite so distant. In accordance with that practice,

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

the staff had planned to present alternative specifications through the end of 1972 in the blue book prepared for the next meeting.

Mr. Kimbrel observed that at their meeting last week the directors of the Atlanta Bank had expressed considerable concern about inflationary psychology, with the thought in mind that economic activity would continue strong. He shared that concern, and he hoped the System would not find itself in the position of financing an inflation. Accordingly, he had some sympathy with the views Mr. Leonard had expressed today and he was prepared to accept the alternative C growth rates for the monetary aggregates. However, he would also find acceptable a continuation of the recent growth rates as called for by alternative B.

Mr. Mayo said he concurred in Mr. Robertson's view that the Committee had little choice today but to adopt alternative B. He found all of the specifications shown under B in the blue book to be acceptable except for the lower end of the range shown for the Federal funds rate. In principle, he favored specifying a sizable range for the funds rate--of about the order of magnitude shown under the various alternatives--but under present conditions he would be inclined to agree with those who thought the lower limit should be set above 4 per cent. He would not want to go as high as 4-1/2 per cent, since that might result in problems with respect

to the discount rate and perhaps create other pressures, but a 4-1/4 per cent lower limit would appear to be reasonable.

Mr. MacLaury concurred in Mr. Mayo's remarks.

Mr. Mayo then noted that the first paragraph of the draft directive included the following statement: "In June the unemployment rate declined, but it was still substantial." In view of the uncertainties surrounding the June unemployment figure, he thought it might be desirable to delete the second clause, or perhaps the whole sentence.

After discussion, the Committee decided to retain the sentence in question.

Mr. Daane remarked that he would not want to make any change in the stance of monetary policy at this juncture. Accordingly, he favored the specifications of alternative B, as shown in the blue book. Also, he would not be inclined today to modify the language in the third paragraph of the draft directive describing the Committee's policy, although he agreed with Mr. Hayes that it would be desirable to have the staff develop some possible alternative language for consideration by the Committee at a later time.

Mr. Daane then said he might make an additional comment bearing on the Chairman's earlier exchange with Mr. Hayes about the experiment the Committee had had under way since February.

While that experiment called for placing primary emphasis on RPD's and the monetary aggregates, at no time had he sensed a desire on the Committee's part to ignore interest rates, in terms of either level or movement; indeed, one of the specifications called for under the experiment related to the constraint to be placed on changes in the Federal funds rate. He did not happen to agree with Mr. Hayes' proposal today to raise the lower limit specified for the funds rate to 4-1/2 per cent, since he thought the resulting range would be too narrow. But he did want to underscore the importance of avoiding any suggestion that the Committee was prepared to ignore interest rates.

In that connection, Mr. Daane continued, he would not be unhappy if under the B specifications the funds rate were to edge up a bit in the coming period and Treasury bill rates were to return to the levels prevailing earlier this month. He agreed that such minor changes would not have a great deal of effect on international financial flows, but whatever effect they had would represent a gain.

Mr. Robertson said he believed interest rates might well edge up in the coming period as the Desk sought to achieve the Committee's objectives with respect to the aggregates. He thought in that event that the Desk should permit the rate movement to proceed and not try to offset it.

Chairman Burns then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and alternative B for the operational paragraph. 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.

Mr. Coldwell said he planned to dissent from the proposed directive. In his judgment continued growth in the money supply at a 6-1/2 per cent annual rate, and the associated expected rate of growth in bank reserves, might build a base for excessive stimulation. He had in mind both the domestic economy, when viewed in the context of heavy stimulation from fiscal policy, and the international financial problems facing the nation.

With Mr. Coldwell dissenting, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions for the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting suggests that real output of goods and services increased at a faster rate in the second quarter than in the two preceding quarters. In June the unemployment rate declined, but it was still substantial. Wholesale prices of farm and food products advanced appreciably further in June and the rise in prices of industrial commodities remained substantial. Recent data suggest moderation in the pace of advance in wage rates. In foreign exchange markets, following disturbances leading to a floating of the pound sterling, the dollar has come under pressure and the

reserves of European central banks have increased sharply. In May, the excess of merchandise imports over exports remained large, though a little less than in April.

Growth in the narrowly defined money stock was relatively slow in May and June, but preliminary weekly data suggest a pickup in early July. Growth in the broadly defined money stock was more substantial as inflows of consumer-type time and savings deposits to banks remained strong. Expansion in the bank credit proxy slowed sharply in June as U.S. Government deposits declined markedly. In recent weeks, long-term interest rates have changed little; rates in short-term markets have advanced, except for those on shorter-maturity Treasury bills.

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 the forthcoming Treasury financing, developments in capital markets, and international developments, 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.

Messrs. Kiley and Ring entered the meeting.

Chairman Burns observed that a memorandum had been distributed from Messrs. Kiley and Holmes, entitled "Proposed revision of procedures for allocation of securities in System Open Market Account," and dated July 13, 1972.[1/] He asked Mr. Holmes to comment.

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

Mr. Holmes remarked that, as noted in the memorandum, on a number of recent occasions the gold certificate account of a Reserve Bank had been temporarily reduced to overdraft status as a result of abnormally large transactions in the Interdistrict Settlement Fund. Such overdrafts could be avoided by temporary reallocations of securities in the System Open Market Account; in effect, the overdrawn Reserve Bank would sell securities to another Reserve Bank, and the transaction would be reversed as soon as the deficiency was eliminated by changes in the direction of the underlying flows of funds. Such a procedure had, in fact, been followed in connection with an overdraft which occurred on Wednesday July 5, and which--if not corrected--would have been reflected as a negative balance in the gold certificate account in the Reserve Bank's weekly statement. That action had been taken despite the lack of specific authority after consultation with the Director of the Board's Division of Federal Reserve Bank Operations, in the belief that under the usual circumstances that had arisen it would be approved by the Committee.

The current proposal, Mr. Holmes continued, was to revise the statement of System Account allocation procedures to provide explicitly for temporary adjustments in between the regular monthly reallocations when they were desirable in the judgment of the Director of the Board's Division of Federal Reserve Bank Operations and the System Account Manager. Unless the Committee decided otherwise, the staff would plan to make interim reallocations only to correct temporary

overdrafts that occurred on a Reserve Bank statement date, and to reverse such adjustments as soon thereafter as was convenient. He might note that, prior to March 1968, the procedures in effect had included a provision for interim reallocations whenever there was a deficiency in the gold reserve requirement of a Reserve Bank, but the provision had been dropped because of the termination of legal gold reserve requirements at that time.

After discussion, the Committee agreed that the proposed revision in the procedures was appropriate.

> By unanimous vote, the procedures for allocation of securities in the System Open Market Account were revised to read as follows:

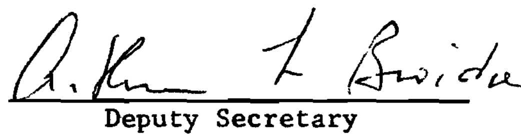
1. Securities in the System Open Market Account shall be reallocated on the last business day of each month by means of adjustments proportionate to the adjustments that would have been required to equalize approximately the average ratios of gold holdings to note liabilities of the 12 Federal Reserve Banks based on the ratios of gold to notes for the most recent five business days.

2. Until the next reallocation the Account shall be apportioned on the basis of the ratios determined in paragraph 1, except that temporary interim adjustments may be made in the apportionments for two or more Banks when desirable in the judgment of the Director of the Board's Division of Federal Reserve Bank Operations and the Manager of the System Open Market Account.

3. Profits and losses on the sale of securities from the Account shall be allocated on the day of delivery of the securities sold on the basis of each Bank's current holdings at the opening of business on that day.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, August 15, 1972, at 9:30 a.m.

Thereupon the meeting adjourned.



Deputy Secretary

ATTACHMENT A

CONFIDENTIAL (FR) July 17, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on July 18, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services increased at a faster rate in the second quarter than in the two preceding quarters. In June the unemployment rate declined, but it was still substantial. Wholesale prices of farm and food products advanced appreciably further in June and the rise in prices of industrial commodities remained substantial. Recent data suggest moderation in the pace of advance in wage rates. In foreign exchange markets, following disturbances leading to a floating of the pound sterling, the dollar has come under pressure and the reserves of European central banks have increased sharply. In May, the excess of merchandise imports over exports remained large, though a little less than in April.

Growth in the narrowly defined money stock was relatively slow in May and June, but preliminary weekly data suggest a pickup in early July. Growth in the broadly defined money stock was more substantial as inflows of consumer-type time and savings deposits to banks remained strong. Expansion in the bank credit proxy slowed sharply in June as U.S. Government deposits declined markedly. In recent weeks, long-term interest rates have changed little; rates in short-term markets have advanced, except for those on shorter-maturity Treasury bills.

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 the forthcoming Treasury financing, developments in capital markets, and international developments, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat faster growth in monetary aggregates over the months ahead.

Alternative B

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

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

July 18, 1972

Points for FOMC Guidance to Manager in Implementation of Directive (As agreed upon 2/15/72)	SPECIFICATIONS (As agreed, 7/18/72)
1. Desired rate of growth in aggregate reserves expressed as a range rather than a point target.	3-7% seas. adj. annual rate in RPD in July-August
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)

	July	Aug.	3rd Q
M_1:	10.5	2.0	6.5
M_2:	11.5	6.0	8.5
Proxy:	5.0	6.5	8.5

Description of contingency plans approved by Committee members on June 29, 1972

On June 29, 1972, available members of the Committee were informed of discussions under way with U.S. Treasury officials concerning possible means for mitigating some of the adverse consequences for Federal finance of any delay in the enactment of new debt ceiling legislation then pending before Congress. It was noted that the legislation in question provided for extension of the temporary $450 billion debt ceiling until October 31, 1972, and that if it were not enacted the following day the debt ceiling would decline to its permanent level of $400 billion, more than $25 billion below the debt estimated to be actually outstanding. In that event, until new debt ceiling legislation was enacted (or until the outstanding debt declined below $400 billion), the Treasury would be unable to issue new securities (including U.S. savings bonds) or to replace maturing securities. It was noted among other things that during the following week the Treasury might not be able to deliver to successful bidders the $4.1 billion of Treasury bills scheduled to be auctioned on June 30, or to roll over nonmarketable securities which had been sold earlier to foreign monetary authorities and which matured then.

The contingency plan under discussion was for the System to purchase directly from the Treasury late on June 30 up to $5 billion of Treasury securities, the maximum direct purchases authorized by law, if it appeared likely that the debt ceiling legislation would be delayed. It was proposed that the System acquire $4.1 billion of Treasury bills, for the purpose of delivering such bills to successful bidders in the June 30 auction in the event that the Treasury was unable to make delivery; and to acquire up to $900 million of other Government securities for the purpose of resale to eligible purchasers. The plan also provided for a revision to be made in the procedures currently in effect for allocating securities in the System Open Market Account, in the event securities acquired from the Treasury included any U.S. savings bonds. This revision was deemed desirable for administrative reasons.

All members of the Committee (except Messrs. Burns and Hayes, who were absent from the country, and with Mr. Treiber acting as alternate for Mr. Hayes) voted contingent approval of the actions set forth below. The members approved the following special FOMC authorization, contingent on a determination by the Vice Chairman of the Board of Governors that it was in the national interest in light of delay in the enactment of new debt ceiling legislation:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York to purchase directly from the Treasury, on June 30, 1972, for System Open Market Account, up to $4.1 billion of Treasury bills maturing on October 5, 1972, and January 4, 1973, at rates equal to the average rates established in the Treasury's bill auctions on that date; and, if the Treasury is unable to deliver the bills auctioned on June 30, 1972, because of delay in enactment of new debt ceiling legislation, to resell to successful bidders in that auction, for delivery on Thursday, July 6, 1972, such amounts of three- and six-month bills as they would have received, at the prices they would have paid, had the Treasury been able to deliver the bills auctioned.

The Federal Reserve Bank of New York is also authorized and directed to purchase directly from the Treasury, on June 30, 1972, for System Open Market Account, up to $900 million of other U.S. Government securities at interest rates comparable to prevailing rates on Government securities of similar type and maturity, and to resell such securities to eligible purchasers.

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

The members also approved an amendment to paragraph 2 of the procedure for allocation of securities in the System Open Market Account, specifying that Reserve Bank participations in System Account holdings of U.S. savings bonds could be apportioned on any basis deemed reasonable by the Federal Reserve Bank of New York, contingent on the acquisition of any savings bonds by the System on June 30.

New debt ceiling legislation was passed by the Congress late in the day on June 30, and the Treasury advised that it was unnecessary to implement the contingency plans. (The legislation was subsequently signed into law by the President on July 1.) Accordingly, the Vice Chairman of the Board of Governors did not make the determination that the special authorization was in the national interest, and that authorization did not become effective. Similarly, the amendment to System Account allocation procedures did not become effective.

MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, July 18, 1972, at 2:45 p.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Bucher
Mr. Coldwell
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Robertson
Mr. Sheehan
Mr. Winn

Messrs. 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. Broida, Deputy Secretary
Mr. Hackley, General Counsel
Mr. Partee, Senior Economist
Mr. Solomon, Economist (International Finance)
Mr. Bryant, Associate Economist
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors

Messrs. Leonard and Merritt, First Vice Presidents, Federal Reserve Banks of St. Louis and San Francisco, respectively

Chairman Burns said he had called this special meeting of the Committee to discuss certain proposed operations in the international area, following the receipt of some important information from the Treasury after the adjournment of this morning's meeting.

By way of background, the Chairman observed that despite the atmosphere of unease that had prevailed in the international financial world for a good many months, the United States--the only nation capable of exerting effective leadership--had appeared to be playing a passive role, with no clear-cut policy or program. As the members would recall, he had outlined certain principles of world monetary reform in his speech at the International Monetary Conference in Montreal last May. He had made that address reluctantly, since he would have preferred to have such a statement come from the Treasury Department. It had seemed necessary for him to speak out, however, because a certain hopelessness and despair had settled on international financial markets. His remarks had received world-wide acclaim, not because of their intrinsic merit, but because of the widespread hunger for leadership; they represented the first outgoing, constructive statement by a senior U.S. official indicating a willingness on this country's part to help in reestablishing monetary order and discussing the means by which order could be reestablished.

As noted in this morning's meeting, the Chairman continued, the foreign exchange markets were presently in a new crisis. Up to this point the United States had played the role of a sympathetic observer, as if it were of no concern to this nation that an additional $6 billion or so had moved into the reserves of foreign

central banks within the past month. For a number of days the Board members had been considering what the Federal Reserve might do in this situation. They recognized that while the System had only limited authority to act on its own, it had a duty to advise the Administration and to urge that the necessary actions be taken. There were times for blowing a trumpet within the halls of Government, and this was one of them. Those efforts had now produced results.

As the Committee knew, Chairman Burns said, when the President had announced his new economic program last August he had directed the Secretary of the Treasury to request the System to suspend the virtually automatic use of its swap network for converting dollars into other currencies. He (Chairman Burns) had just been informed by the Treasury that the suspension of the System's use of its swap network had been lifted. It would now be possible for the Federal Reserve to reactivate the swap lines and to draw foreign currencies whenever it believed that sales of those currencies would have a useful effect in helping to reestablish orderly conditions in the foreign exchange markets. By demonstrating that the United States was prepared to cooperate with other nations in defending the Smithsonian parities, such operations could have a major impact on market psychology. Even if their direct effects were more limited, however, they would

still be helpful in improving the atmosphere for the coming negotiations on permanent international monetary reform.

The Chairman remarked that some details of the program remained to be worked out. However, the general outlines were clear and Mr. Coombs, who had participated in the preliminary discussions, might describe them at this point.

Mr. Coombs observed that the proposed technique--under which the System would draw on the swap lines to obtain currencies for sale in the market--was similar to the approach that had originally been contemplated when the swap network was established in the early 1960's. In the intervening years, however, the foreign central banks had generally preferred to take in dollars from the market themselves and then have the System draw on the swap lines for the purpose of covering their excess dollar holdings with a guarantee against a dollar devaluation. They had preferred that procedure partly because it was technically simpler--i.e., it avoided the problem of coordinating joint market intervention by the Federal Reserve and the foreign central bank concerned. Furthermore, their preference was buttressed by the fact that they had the legal right under the Bretton Woods Agreement to exchange dollars with the U.S. Treasury for gold. That option was, of course, no longer available.

Under the present plan, Mr. Coombs continued, drawings would be made by the System exclusively for use in the market, with the broad objectives of demonstrating the determination of this country to join in the defense of the Smithsonian agreement and of affirming its confidence that most of the Smithsonian parities were appropriate and worth defending. Since there was serious question about the appropriateness of the present parity for the Japanese yen, no operations would be undertaken in that currency. As to the occasions for operations, the most obvious would be a speculative flurry in which a foreign currency moved to its ceiling; in that event, the Federal Reserve and the foreign central bank involved would operate side by side, both buying dollars. The System would hold to the principle that the primary responsibility for defending the parity lay with the foreign central bank, and that the System's purchases should at most be a small fraction of those made by the foreign bank. Whether the System's purchases were made in the foreign market, in New York, or in both markets was a question to be resolved in consultation with the central bank involved.

A second possible occasion for operations, Mr. Coombs remarked, might arise if there were some improvement in sentiment and a consequent dip from the ceiling in the exchange rates for some currencies, such as had occurred in May of this year. Under

those circumstances, aggressive central bank operations might have a snowballing effect, forcing the rate sharply away from the ceiling. Such a tactic had succeeded in 1965, when coordinated operations by the System and the Bank of England had moved sterling sharply upward. There was no certainty, of course, that that success could be repeated.

In whatever operations were considered, Mr. Coombs observed, the System would have to rely heavily on the judgment of the foreign central bank regarding the reasons for particular flows in its currency and, consequently, the likelihood that intervention would have useful results. With that qualification, the System would retain full discretion with respect to the timing and magnitude of its operations. In particular, he thought the System should resist any pressures that might be brought to bear to undertake larger operations than it had independently decided would be appropriate.

Chairman Burns noted that conditions in foreign exchange markets had been quiet for the past 2 days. That made the present a particularly auspicious time for the System to demonstrate its willingness to intervene in defense of the Smithsonian parities. While present plans did not call for an advance announcement, once the operations were launched they would no doubt become known to market participants and others very quickly.

Mr. Daane said the impressions he had received on his recent European trip certainly served to confirm the Chairman's remarks about the hunger abroad for U.S. leadership and the desirability of demonstrating this country's willingness to cooperate in the defense of the Smithsonian parities. On a procedural matter, he noted that System officials would be talking with officials of foreign central banks about reactivating the swap lines. He asked whether it might not be desirable for Chairman Burns to talk first with the governors of those banks, in order to inform them of the System's intentions.

Mr. Coombs replied that in his judgment it would be highly desirable for the Chairman to hold such preliminary conversations; among other things, they would provide an opportunity to make clear that the program had the backing of the Administration as well as the Federal Reserve.

Mr. Robertson observed that the primary purpose of the program, as he understood it, was to affect market psychology--in particular, to influence the attitudes of those who recently had moved funds from dollars into foreign currencies or were presently thinking of doing so. In his judgment, that purpose would be best served if the System were to issue an announcement concerning the program.

Mr. Brimmer agreed. He remarked that it would be better to have information regarding the program come from the System than from outside observers who were drawing inferences from market developments. Also, there were advantages in making the information available simultaneously to everyone concerned.

Chairman Burns said he also saw advantages in a public announcement, particularly as a means of getting the maximum amount of favorable attention promptly. However, the Treasury was inclined to the view that there were greater advantages in the alternative procedure of letting the operations speak for themselves, in the traditional fashion of central banks. While the matter was still open for discussion, he would not want to issue an announcement if the Treasury held to its present position.

Assuming there was no announcement, the Chairman continued, the press and the public would no doubt begin directing questions to various System officials very soon after the operations were launched. It would be desirable, he thought, for all such inquiries to be referred to him, at least initially.

Mr. Brimmer remarked that there might also be some problem in contacts at the operating level between the System and other central banks. He hoped it would be possible to avoid a situation in which incomplete reports were circulating prematurely.

Mr. Coombs agreed. At the moment he was not sure whether it would be better for him to hold technical discussions with officials of the central banks involved on a bilateral basis or to meet with them jointly. He hoped to be in a position to make recommendations on that point to Chairman Burns by tomorrow morning.

In response to a question by Mr. Heflin, the Chairman reported that he had been advised orally that the suspension of the System's use of its swap network had been lifted. He agreed with Mr. Heflin's suggestion that it would be desirable to have in the record a formal communication on the matter from the Treasury.[1/]

In reply to questions by Messrs. Brimmer and Kimbrel, Mr. Coombs said he would not contemplate drawing either sterling or Italian lira for market operations under the new program, since exchange rates for both of those currencies were already well below their Smithsonian ceilings. Indeed, sterling looked so weak at the moment that the System might well accelerate the purchases now under way for the purpose of liquidating its outstanding sterling debt. As to other currencies, he had already noted that no operations in yen were contemplated because of doubts as to the appropriateness of its present parity. Also, he would not be inclined to operate in Swiss or Belgian francs. The System already had substantial debt outstanding in those

1/ A copy of a letter subsequently received from Secretary Shultz is appended to this memorandum as Attachment A.

currencies; moreover, it would be prudent to avoid operations in them until the effectiveness of the exchange controls imposed by Switzerland and Belgium had been demonstrated. That would narrow the main possibilities down to the German mark, the Dutch guilder, and the French franc. Operations in the mark were particularly likely to be productive; the mark was a bellwether currency at present, and changes in its value probably would have important sympathetic effects on the values of other currencies.

The Chairman observed that Mr. Coombs would no doubt make it clear to officials of other central banks that his market operations were not intended to aid or to injure any currency, but were directed solely at the objective of reestablishing order in the foreign exchange markets as a whole.

In reply to a question by Mr. Hayes, Chairman Burns said that the Treasury might undertake market operations, through the Exchange Stabilization Fund, in those currencies which were close to their ceilings and in which the System already had substantial swap debt outstanding.

Mr. Coldwell observed that the Committee recently had approved the renewal of a rather large number of swap drawings that kept individual swap lines in active use for more than a year. Nevertheless, it had been a long-standing System policy that drawings were to be limited to situations which were considered to be of a short-run nature. He asked whether that policy would be maintained under the new program.

Mr. Coombs noted that the foreign currency authorization set a one-year limit on the continuous use of any swap line except when the Committee decided that exceptional circumstances warranted a delay beyond that period in clearing up a line. He would not propose a change in that policy. As in the past, any drawings would be on a three-month renewable basis.

Chairman Burns added that the members should nevertheless recognize clearly that the program on which it was now proposed to embark might well result in borrowings that would not be repaid within a year. Personally, he found such long-term borrowings disturbing, and he had planned before the current crisis to press for repayment of the System's outstanding swap debts as soon as possible. However, the Committee was now faced with a new situation.

In reply to a question by Mr. Robertson, Mr. Coombs said it was contemplated under the program to make drawings only for the purpose of absorbing new dollar flows--in fact, only a portion of such flows.

Mr. MacLaury observed that the proposal made good sense to him. He asked whether the question that had been raised earlier about the status of the revaluation guarantee in the System's swap lines with the German Federal Bank and other Common Market central bank had been resolved.

Mr. Coombs replied that the matter of the revaluation clause was still under negotiation. He hoped it would be possible to learn quickly what the Common Market central banks were willing to do in that connection.

Mr. MacLaury then asked whether there were any other measures that might be taken to help in the present situation. For example, was the Board considering action with respect to reserve requirements on Euro-dollar borrowings of U.S. banks, or with respect to Regulation Q ceilings on large-denomination CD's?

Chairman Burns remarked that while the Board had the first of those possibilities under consideration at the moment, he doubted that action in either area would have a significant impact on prevailing conditions in the foreign exchange markets. More important effects could be expected from modifications in the program of direct foreign investment controls and the System's foreign credit controls on banks, but he doubted that such modifications were feasible at present. Also, the Treasury could make a drawing on the International Monetary Fund to supplement the System's drawings on its swap partners and whatever actions the Exchange Stabilization Fund might undertake. Indeed, a public announcement that measures were being taken in all three areas could have a dramatic effect on the exchange markets.

However, the Treasury was not inclined to draw on the Fund at this time. Their position was understandable; a Fund drawing would be accompanied by a great deal of publicity, it would raise questions of surveillance, and it would accomplish nothing that could not be accomplished with System drawings on the swap lines.

Mr. Morris asked whether any thought had been given to operations in the forward market.

Mr. Coombs replied affirmatively. He noted that forward operations had been used with great effectiveness at times in the past, including the period after the devaluation of sterling in 1967. As that operation had demonstrated, relatively small transactions could have a large impact on forward rates and could produce important changes in market psychology. At present he would suggest beginning with operations in the spot market and later discussing with the Treasury the possibility of reinforcing those operations with forward transactions.

Mr. Coldwell asked whether there was any possibility of *de facto* third-party swaps. What he had in mind was a situation in which country A dumped dollars on country B, and the System absorbed B's dollar holdings by drawing on the swap line.

Mr. Coombs replied in the negative. He found it hard to imagine a major industrial country acting in the manner described by Mr. Coldwell. If some country did so, however, he doubted that the System should intervene.

Chairman Burns remarked that actions of the kind Mr. Coldwell hypothesized would amount to launching a currency war and would certainly bring reprisals. Accordingly, he agreed with Mr. Coombs that they were unlikely.

Mr. Mayo said he thought the proposed program would be constructive. He then asked whether System operations in European currencies might have some useful secondary effects on the problem associated with the Japanese yen.

Mr. Coombs replied that improvement in the market situation of European currencies certainly would not aggravate the yen situation and conceivably could help it a little. The problem of the yen exchange rate was a structural one, however, and it was unlikely that it could be significantly eased by any action the System might take.

Mr. Eastburn asked about the probable effects of the contemplated operations on sterling.

In reply, Mr. Coombs observed that sterling's present difficulties reflected two-sided speculation--on a decline in the sterling exchange rate and on rises in the exchange rates of other European currencies to which it was bound through the Common Market monetary agreement. The System's operations would help sterling to the extent that they moderated the second kind of speculation. In his judgment, however, the sterling problem was

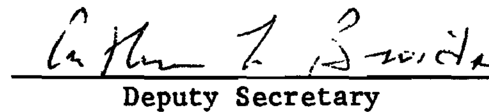
not likely to be resolved until an appropriate new fixed exchange rate had been established.

Mr. Sheehan said he thought Chairman Burns, who was primarily responsible for the latest turn of events, should be congratulated.

Mr. Hayes agreed. While he had not participated directly in the recent discussions, he was highly pleased with the outcome.

Chairman Burns observed that the main burden of carrying out the program would rest on Mr. Coombs. That was a heavy responsibility, but Mr. Coombs had demonstrated his ability to deal successfully with difficult problems many times in the past.

Thereupon the meeting adjourned.



Deputy Secretary

ATTACHMENT A

THE SECRETARY OF THE TREASURY
WASHINGTON

Dear Mr. Chairman:

I want to confirm our understanding in conversations on and before July 18, 1972, with respect to intervention in foreign exchange markets.

Such market intervention by the Federal Reserve will require resources of foreign exchange that can most readily be obtained from recourse to use of the existing swap network. On August 15, Secretary Connally requested the suspension of the virtually automatic use of your swap network for the purpose of converting dollars into other currencies, while noting the future operation of these and other mutual credit facilities will be determined in the light of emerging developments. I have agreed the planned Federal Reserve intervention in exchange markets will require use of the swap facilities for that purpose.

In undertaking these operations, we agreed that market operations will be conducted in close day-to-day consultation with the Treasury, and I noted the Exchange Stabilization Fund might, when convenient and desirable, engage in such intervention on behalf of the Treasury.

Sincerely yours,

George P. Shultz

The Honorable
Arthur F. Burns
Chairman, Federal Reserve Board
Washington, D. C. 20551