MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C. on Tuesday, June 18, 1974, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Black
Mr. Brimmer
Mr. Bucher
Mr. Clay
Mr. Holland
Mr. Kimbrel
Mr. Mitchell
Mr. Sheehan
Mr. Wallich
Mr. Winn
Mr. Debs, Alternate for Mr. Hayes

Messrs. Coldwell, MacLaury, Mayo, and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Eastburn and Balles, Presidents of the Federal Reserve Banks of Philadelphia and San Francisco, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Brandt, Bryant, Doll, Gramley, Hocter, Parthemos, Pierce, and Reynolds, Associate Economists

Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Feldberg, Secretary to the Board of Governors
Mr. Wonnacott, Associate Director, Division of International Finance, Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors
Messrs. Keir and Wernick, Advisers, Division of Research and Statistics, Board of Governors
Mr. Struble, Senior Economist, Division of Research and Statistics, Board of Governors
Miss Pruitt, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Mr. Leonard, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Eisenmenger, Boehne, and Sims, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and San Francisco, respectively
Mr. Garvy, Vice President and Senior Adviser, Federal Reserve Bank of New York
Messrs. Jordan and Green, Vice Presidents, Federal Reserve Banks of St. Louis and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Kalchbrenner, Senior Economist and Assistant Vice President, Federal Reserve Bank of Chicago
Mr. Sandberg, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on May 21, 1974, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on May 21, 1974, was accepted.

Secretary's note: A resumè of the governors' discussion at the annual meeting of the Bank for International Settlements, held on June 9, 1974, is appended to this memorandum as Attachment A. The System was represented at the meeting by Presidents Hayes and MacLaury and Mr. Pardee of the New York Reserve Bank.

Chairman Burns asked Mr. Bryant to comment on the meeting of the Committee of Twenty that had been held in Washington on June 12-13, 1974.

Mr. Bryant noted that copies of the communique issued last week at the close of the sixth and final meeting of the Committee of Twenty had been distributed to FOMC members. That document and its attachments were largely self-explanatory, and he would not try to summarize them.

Of the various items of "immediate action" agreed to by the C-20, Mr. Bryant observed, he would call the members' attention to four in particular. First, it was agreed to establish an Interim Committee to advise the IMF Board of Governors, pending formal amendment of the Fund's Articles of Agreement to create a permanent Council. Both the Interim Committee and the permanent Council were to have a make-up similar to that of the C-20 itself. The torch of international monetary reform was being formally passed to those new bodies.

Second, Mr. Bryant continued, agreement was reached on a set of guidelines for the management of floating exchange rates. Those guidelines, although quite general in nature, did provide a basis for the international community, acting through the IMF, to engage in a dialogue with individual countries about not only their market intervention practices but also other policy actions designed to affect their exchange rates. It remained very much to be seen if and how the new authority embodied in the guidelines would be exercised by the Fund and how member countries would respond. Third, agreement was reached on procedures for valuation of the SDR and its rate of interest, to be applicable over the next 2 years. Broadly, the SDR would now be valued as a weighted average of 16 major currencies, with the U.S. dollar having a weight of 33 per cent. The interest rate on the SDR was to be set at 5 per cent, with provisions for adjusting the rate upwards or downwards in accordance with changes in an average of short-term market rates in the United States, Germany, Japan, the United Kingdom, and France.

Mr. Bryant remarked that a fourth significant action taken last week was the establishment of the special Oil Facility in the IMF. That Facility would borrow funds from certain member countries, particularly some of the oil exporters, and make the proceeds available for borrowing by other member countries needing to cushion the impact of higher petroleum prices on their balance of payments.

Mr. Bryant observed that it was almost surely too soon to assess accurately the practical importance of those four--and the other--actions taken last week, just as it was probably too early to set the work of the Committee of Twenty itself in a clear, balanced perspective. Thus, it was his inclination to stop without any effort to philosophize on the question: "What, if anything, did the Committee of Twenty really accomplish in its 22 months of laboring?" He was also encouraged to spare the FOMC an attempt to sum up at this point because he felt fairly confident that the subject of the reform of international monetary arrangements had not slipped quietly into history last Thursday with the formal passing of the Committee of Twenty. Last week's meeting was a benchmark, the end of a chapter. But unless his guess was quite mistaken, there was a good bit of the story still ahead--perhaps even the most exciting chapters.

Mr. Wallich said that if he were to philosophize a bit on the meaning of the C-20 meeting, it suggested to him that the international economy was entering a period in which cooperation would be more important than it had been under the old system. The dollar was vulnerable, in a sense, because it was widely used as an intervention currency; he feared that exchange rates for the dollar would tend to be determined more by the actions of other countries than by

those of the United States. Under such circumstances, cooperation would be necessary to avoid competitive appreciations and depreciations and trade restrictions. Central banks could do much in that connection; indeed, their ability to cooperate was one of their traditional strengths. Perhaps the best approach would be to work out some kind of continuing understanding with a small number of countries--such as Japan and Germany--as a first step, and then to broaden the understanding to include other countries.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period May 21 through June 12, 1974, and a supplemental report covering the period June 13 through 17, 1974. Copies of these reports have been placed in the files of the Committee.

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

> Since the last meeting of the Committee the dollar has been doing somewhat better on the foreign exchanges. The recovery began around the middle of May following press reports of a Swiss, German, and Federal Reserve agreement on concerted intervention. Then came the pleasantly surprising news of a U.S. trade surplus in April, while the German trade figures for the same month seemed to be showing signs of topping off after a very strong performance. Chairman Burns' strong statements regarding System credit policy lent further buoyancy to the

dollar. Finally, market expectations of a further revaluation of the mark to relieve the financial strains afflicting the Common Market have tended to fade away. The main thrust of Common Market policy now seems to be insistence on corrective domestic action by both Italy and France as a price of German and other official credits. I think this is all to the good. Further jiggling of exchange rates in the current inflationary situation would probably do more harm than good.

There is one other favorable factor of which the market is probably not yet fully aware. At a recent meeting of the Common Market Finance Ministers, it was agreed that the German Federal Bank would seek to relieve pressures on its partners in the European snake by intervening more heavily in the dollar market as compared with its intervention in the partners' currencies. Last year and so far this year, the main intervention operations of the Federal Bank took the form of supplying marks against the currencies of its Common Market partners whenever the mark rose to the top of the European monetary band. Now the Federal Bank has apparently committed itself to try to keep the mark from rising to the top of the European band by intervening more heavily in the dollar market. This new policy was initiated during a period when the dollar had become reasonably strong, and as a result the Germans have been able to sell quite a few more dollars than they bought during the period. If they adhere to the new policy even when market pressures turn against the dollar, we might hope that the Federal Bank would intervene fairly heavily in support of the dollar at rates not very far below current levels. I think this, in turn, would have a favorable effect on market psychology; there still are enormous positions that are long in marks and short in dollars, and the appearance of a semblance of stability in the rate could lead to a certain amount of unwinding of those positions.

In our operations we have tended to follow the lead set by the German Federal Bank in their operations in Frankfurt before the New York opening. This involved the sale of $17 million of marks on June 7, our first support operation since late April, which

> was financed by an additional drawing on the Federal Bank, thereby increasing our swap debt in marks to $382 million equivalent. On the other hand, we took advantage on several occasions of strong dollar rates to buy $65 million of German marks which we are currently holding in invested balances. The dollar has strengthened a bit more this morning and the System might be able to buy marks today.

Chairman Burns asked Mr. Bryant whether he would like to offer any comments at this point.

Mr. Bryant said he might simply note that he was quite concerned about the Italian situation, not only because it was important in its own right but also because it might be the first example of the kinds of strains that would be created by the oil financing problem. He was sure that the Committee members were well aware of that possibility.

In reply to a question by Mr. Mitchell, Mr. Coombs said he was not prepared to recommend a further tightening of monetary policy for the purpose of strengthening the dollar exchange rate; the Committee's policy decision no doubt would be based primarily on the needs of the domestic economy. It was true, of course, that a tightening of policy would tend to improve the position of the dollar.

> By unanimous vote, the System open market transactions in foreign currencies during the period May 21 through June 17, 1974, were approved, ratified, and confirmed.

Mr. Coombs noted that three System drawings on the German Federal Bank, totaling $90.5 million, would mature for the first time in the period from July 1 to 26. While it might prove possible to repay a portion of those drawings before maturity, he would recommend their renewal to the extent they could not be repaid.

Renewal for further periods of 3 months of System drawings on the German Federal Bank maturing in the period July 1-26, 1974, was noted without objection.

Mr. Coombs then observed that two System drawings on the National Bank of Belgium, totaling $31.8 million, would mature for the twelfth time on July 18 and 25. He would recommend renewal of those drawings to the extent they were not repaid by their maturity dates. Since the Belgian swap line had been in continuous use for more than a year, express Committee approval was required for their renewal under the provisions of paragraph 1D of the foreign currency authorization.

Mr. Holland asked about the prospects for paying down the System's Belgian franc debt.

Mr. Coombs said he had planned to mention two recent developments in connection with the System's long-standing problem of paying off its swap debts in Belgian francs and Swiss francs. As the members would recall, in a letter to the Belgian Finance Minister

last winter the U.S. Treasury had urged the Belgians to honor the guarantee in the swap contract in connection with the 2-3/4 per cent revaluation of the Belgian franc made at the time of the Smithsonian Agreement in December 1971. In a recent letter the Belgian Finance Minister had finally indicated his willingness to seek his Government's approval of that course, and a Treasury response was now being prepared.

Meanwhile, Mr. Coombs continued, there apparently also had been some softening of the Swiss position regarding the System's outstanding debt in Swiss francs. For more than a year the Swiss franc had generally been floating well above the parity level corresponding to the February 1973 devaluation of the dollar. In a telex last winter the Treasury had urged the Swiss to consider the upward float of the franc as tantamount to a revaluation and hence covered by the revaluation guarantee. That would have meant that the Swiss would incur the entire loss resulting from the franc's upward float, and they had flatly rejected the proposal. In recent conversations with Treasury officials, however, President Leutwiler of the Swiss National Bank had indicated a willingness to consider a 50-50 sharing of any losses incurred by the Federal Reserve in buying Swiss francs at rates above the franc's imputed parity for the purpose of making repayments on the swap debt. Much would depend, of course, on

whether the Swiss would couple such a concession with the insistence that the System refrain from buying francs until the rate moved close enough to parity to minimize losses by both parties. In any event, if agreement were reached with the Swiss on a 50-50 loss-sharing arrangement, the Belgians presumably could be asked to agree to a similar arrangement, since the two situations were comparable.

Mr. Coombs added that he had not yet had an opportunity to discuss the matter with the Swiss authorities and therefore was not sure of the reasons for their recent change of view. It might have been connected, at least in part, with their expectation that they would be called on to extend sizable credits to the Bank of Italy. On several occasions in the 1960's the Swiss had agreed to particular terms for repayment of System swap debts at times when the Bank of Italy was in need of dollar credits, and they had in fact lent to the Italians sums equivalent to the System's repayments.

Mr. Coombs noted that negotiations with the Swiss and Belgians would be proceeding over coming weeks. The agreements worked out with the Swiss in connection with the System's debt presumably would be paralleled in the repayment terms for the Treasury's outstanding Swiss-franc denominated debt to the Swiss National Bank, and the Treasury was likely to be deeply involved in the negotiations. Because intricate technical questions requiring early decisions might arise,

he thought the Committee might want to delegate to the Subcommittee the authority to act on its behalf in the negotiations.

Mr. Holland expressed the view that such a delegation would be appropriate.

> By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium maturing on July 18 and July 25, 1974, was authorized.
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> By unanimous vote, the Subcommittee consisting of the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board of Governors, or designated alternates, was authorized to act on behalf of the Committee with respect to questions relating to the terms of repayment of outstanding System swap debts in Belgian francs and Swiss francs.

Chairman Burns 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 presented the following statement:

> The economic news of the past month has continued to point to modest recovery in over-all activity. But the emphasis in this statement needs to be placed on the word "modest." Thus, industrial production rose again in May, manufacturers' new orders for durable

goods rebounded in April, and nonfarm employment has gained appreciably in each of the last 2 months. Despite this recent improvement, though, industrial output is still below the November 1973 peak, durable goods orders in real terms have been receding on balance since last fall, and the recent growth in employment has been less than expansion in the labor force, so that the unemployment rate has risen.

What appears to have been occurring is a recovery too anemic to utilize the economy's gradually expanding resources, which is in line with earlier staff projections. And the outlook for any appreciable pickup in the pace of recovery is not encouraging. In the consumer sector, retail sales have continued to expand only about as fast as prices, at best. Physical volume has shown no improvement thus far this year, after declining during much of 1973. In housing, both building permit volume and starts dropped back sharply in May, apparently reflecting the tightening mortgage situation. Reports from both builders and lenders suggest that we may be fortunate to maintain even the current level of activity over the balance of the year, though the new program of Government-subsidized financing will be a sustaining factor. In capital spending, the latest Commerce survey of business plans is a little less robust than before, with the small downward revision from the previous survey concentrated in the second half of the year. There is also no pick-up to date in the figures on inventory investment; and there are reports--in the red book[1/] and elsewhere--that the high cost of money is tending to bring downward revisions in inventory plans.

Reflecting some of these considerations, the latest staff projection, presented in the green book,[2/] has scaled down further the extent of the recovery expected in real economic activity over the year ahead. Real GNP is now projected to grow from mid-1974 to mid-1975 at an annual rate averaging somewhat under 2 per cent, about three-quarters of a percentage point less than the growth projected 4 weeks ago. Because of the

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

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

weaker expansion now in prospect, and after allowing for a smaller growth in the labor force, the unemployment rate is expected to rise somewhat faster than before, exceeding 6 per cent in both the first and second quarters of next year. The inflation rate is also projected to average slightly higher, mainly reflecting the current wave of price markups, but still is expected to moderate appreciably in the first half of 1975.

Slow growth in the economy seems an appropriate and necessary objective of public policy, given the severity of our inflationary problems. The May increase in the wholesale price index, though it was dampened by the third month of substantial decline in farm products and processed foods, continued to show extraordinarily large and widespread advances in industrial commodities. Of the 13 major groupings of industrial commodities, all but lumber advanced--in five instances by more than 3 per cent in the one month. And over the first 5 months of this year, the industrial commodities component of the index has increased at a seasonally adjusted annual rate in excess of 30 per cent. This price behavior has been associated with higher fuel costs and the unwinding and termination of price controls, and presumably is now about to moderate. But much of the upsurge has not yet been reflected in retail prices, and this, along with escalating service costs, will be adding to the CPI for many months to come.

The sharp reduction in prices of food products at wholesale also has not been reflected at all fully as yet in the stores; some further decline in this area should help to moderate the rise in the CPI, along with a marked slowing of the price advance for gasoline and heating oil. But the increase in consumer prices generally is bound to continue very substantial and, coming on top of the large rise over the past year or so, to add to the size and strength of employee wage demands. In this environment it is particularly important to encourage doubts about the ability of product markets to absorb all of the increase in costs, and to keep business profits under downward pressure.

At the same time, it is important to avoid a stall in business activity that would compound instances of serious financial difficulty, cause a general pulling back in spending and investment plans, and quickly raise unemployment above levels that are politically and socially acceptable. I would judge that the results of our projection, if realized, would be tolerable, but only marginally so. And I must admit to a concern that our projection may still be too optimistic.

One of my concerns is that we may still be understating the price rise in prospect. It is difficult to judge how fast and how fully wholesale prices will be passed through to retail, and there is a possibility--with business firms newly freed from price controls and anxious to restore profit margins, perhaps before a new controls program comes along--that the impact on consumer prices will be larger than we have estimated. If so, consumer real incomes would continue under downward pressure, at least until higher wages can be won, and real consumer spending could well be even more sluggish than we are projecting. Similarly, it seems to me quite possible that export markets could be weaker than we have projected if foreign financing problems become intense, as in the case of Italy.

Weaker end-product markets would impact on business spending for fixed investment and inventories, of course, but it is also conceivable that the strength of such spending, independently, may be less than we have been estimating. There still appears to be a strong and pressing need for expanded business investment. Capacity remains short in many of the basic industries, profitable conversions of equipment and processes in order to economize on high-cost energy must be possible, and inventories remain generally quite low in relation to order backlogs and sales. But internal sources of funds now are likely to be coming under pressure, and external finance is costly and, for many firms, difficult to obtain. It would not be surprising to see voluntary stretch-outs in capital spending programs and to find businesses attempting to economize on their inventory financing needs far more than has been true in the past. Such tendencies, of course, would lead to lower rates of increase in expenditures during the adjustment period.

> A general erosion in demands of this sort, and the loss of the remaining forward momentum in the economy that this would imply, is a matter of speculation at this point. But we must be watching carefully for confirming signs. I would note also that a general weakening in spending plans would become far more likely if serious trouble should develop in financial markets. Fortunately, that prospect seems somewhat more remote than a month ago, at least domestically, as markets have tended to quiet. But there is a large number of businesses that appear to be facing a significant degree of financial discomfort, including the REIT's, some utilities, some airlines, many builders, and a large part of the cattle industry; there is obviously an exposure to new financial shocks if prominent cases of inability to pay come to light. This is also a risk that is heightened by a continuing policy of monetary restraint, and it will need to be monitored very closely in the weeks and months to come.

Mr. Bucher noted that the assumptions associated with the green book projections included an expanded public employment program. He asked what effect that assumption had on the rate of unemployment projected for 1975.

Mr. Partee replied that the expansion assumed in the presently small public employment program would add about 150,000 to employment in the State and local government sector in mid-1975, and would reduce the over-all unemployment rate then by two-tenths of one percentage point. Thus, it was a significant factor.

Mr. Kimbrel asked whether the terms of recent labor settlements were consistent with the staff's earlier expectations or whether the settlements were running higher than anticipated.

Mr. Partee observed that there had been relatively few labor settlements recently; the only ones he could recall were some scattered settlements in the construction industry, in which very large wage increases had been negotiated. However, it appeared to him that labor demands for increases in compensation were strong and were likely to be backed up, if necessary, by strikes. Moreover, most of the contracts made thus far called for complete cost-of-living protection; therefore, if the CPI were to increase at an annual rate of 7 or 8 per cent over some period, employee compensation under those contracts was likely to increase at a rate of 11 or 12 per cent during that period. The staff projections allowed for an average rate of increase in employee compensation of about 8-1/2 per cent over the next year, a rate which was considerably higher than that of the first quarter of 1974 but not very high by historical standards. That projection was based on the assumptions of a rising rate of unemployment and considerable resistance to wage demands on the part of businesses. However, the rate of increase in the average hourly earnings index had accelerated recently, reaching an annual rate of about 10 per cent in May. It was possible, therefore, that the staff had underestimated the future rate of advance in compensation; if so, the projection of the rate of increase in prices would be too low

and the projection of real consumer spending might be somewhat too high.

Mr. Kimbrel, noting a reference in Mr. Partee's statement to the possibility of a new controls program, asked if the staff contemplated the reimposition of wage and price controls.

Mr. Partee replied that the staff did not expect that to occur. There had been some discussion of possible Congressional action on controls, however, and it seemed reasonable that businessmen would try to protect themselves against that possibility. A feeling by businessmen that they might have only a few months in which to adjust profit margins could account for the extraordinary size of recent price increases.

Mr. Leonard said he agreed with Mr. Partee about the speculative nature of any projections of economic activity for the rest of the year. The staff at the St. Louis Bank believed that the economy was somewhat stronger than suggested by the green book projections. As the Committee members knew, the St. Louis Bank used a somewhat different approach to forecasting--it estimated changes in total spending not as the sum of changes in consumer, business, and government expenditures, but as the product of changes in the money stock and velocity. The St. Louis analysis suggested

that, if the money stock continued to grow at the 7 per cent trend rate of the past 3 calendar years, the growth rate of nominal GNP between the fourth quarters of 1973 and 1974 would be greater than the 8 per cent projected in the green book. Since the Board staff estimate of the change in the price deflator over that period seemed reasonable, the St. Louis staff expected real output to grow somewhat over the period, rather than decline slightly as projected in the green book.

Mr. Partee observed that the Board staff projection did not assume a 7 per cent increase in the money supply. Had it done so, the projection would have been stronger.

Mr. Leonard remarked that, in view of the 8 per cent growth in the first six months this year, it would appear impossible to restrain the growth of money to the 5-1/2 per cent rate assumed in the green book for the last three quarters of the year without throwing the economy into a tailspin.

Mr. Eastburn noted that in a newspaper article published today there had been references to Administration suggestions for tax relief for consumers as well as special tax incentives for investment spending. He asked whether Mr. Partee thought such changes in fiscal policy were likely.

In response, Mr. Partee noted that the fiscal policy assumptions in the latest projections were somewhat more

restrictive than those made 4 weeks earlier. It had been anticipated previously that overwithholding of personal income taxes would be reduced, but that assumption had been dropped because it now seemed unlikely that Congress would act; as a result, the staff's projection of disposable income had been lowered. Secondly, the staff had increased Federal revenue estimates to take account of a small increase in oil industry taxes which was under consideration in Congress. Hearings on other tax actions were being held, but there was no indication at this time of the eventual outcome.

Mr. Wallich commented that it was his impression from reading the red book that businessmen were more optimistic about the economic outlook than appeared to be warranted on the basis of the green book projections. He wondered whether the difference was the result of a lead-lag relationship between the red book and the green book. Presumably, the qualitative information in the red book would lead the quantitative statistics in the green book by some time period. He asked if the staff had any evidence of such a lead-lag relationship.

The Chairman remarked that he had received a somewhat different impression from his reading of the red book. It seemed to him that there was more diversity of opinion than suggested by Mr. Wallich's comment.

Mr. Partee said it was certainly true in principle that the qualitative information on attitudes reported in the red book preceded the statistical information recorded in the green book. However, there was an offsetting tendency for business attitudes to lag reality. In his opinion, businessmen had not yet adjusted to the idea of a near recession in the economy, although they would probably do so within the next few months. The current red book appeared to reflect the long, but now vanishing, period of difficulties with price controls, shortages, and inadequate inventories. He thought an examination of a number of recent red books would indicate that reports of shortages reflected in the most recent edition were less widespread and less strident than had been the case for quite a few months. It was also a matter of interest that in the latest edition there were reports that firms were at least considering cutbacks in capital spending or adjustments in inventory policies. Such instances were seldom reported in other recent red books.

Mr. Mitchell observed that there appeared to be a much more pronounced impact from interest rates than ever before.

Mr. Partee concurred.

Mr. Mitchell then noted that he had been surprised to learn in a recent discussion with an official of a large retail

organization headquartered in the Ninth District that the firm's recent sales performance had been strong, even in real terms.

Mr. MacLaury said he had received a similar report from that official. However, his optimism might simply have reflected a pick-up in sales after a relatively slack month. That official had also reported that during the last month suppliers had been filling his orders completely and had been making much faster deliveries than a few months ago.

Mr. MacLaury added that most of the directors of his Bank were more optimistic about the business outlook than the latest data would appear to warrant. He agreed with Mr. Partee that businessmen's attitudes tended to lag developments.

The Chairman observed that retailers in general were poor forecasters because they did not take adequate account of seasonality or price changes. For example, they tended to make simple comparisons of dollar sales in a given month and in the same month a year earlier.

Mr. Winn noted that most retailers had expected sales to be very weak in the first half of 1974. The fact that sales were better than they had projected no doubt influenced their current attitudes.

Mr. Mayo remarked that two national retail chains headquartered in the Seventh District, both of which maintained price indexes for their own products, reported year-over-year increases in sales in real terms. The index calculated by one firm showed a surprisingly small increase over the past year in the average prices of items sold. While officials of that firm expected future price increases to be much larger, they believed that the deflators applied to recent national retail sales totals were too high.

Mr. Holland noted that the green book projections assumed a growth rate of the money stock consistent with the specifications for alternative C in the blue book.[1/] He asked how the projections of real GNP, the deflator, and unemployment for the fourth quarter would be affected if it were assumed that the money stock grew at a rate consistent with alternative B.

In reply, Mr. Partee said that a shift from the alternative C to the alternative B money supply growth rate would add about $1-1/2 billion to the projected level of real GNP in the fourth quarter of 1974. Shifting to the alternative A money supply growth rate would add another $1-1/2 billion. Such shifts would reduce slightly the

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

unemployment rate projected for the fourth quarter--perhaps by one-tenth of one percentage point--but would have no perceptible effect on the deflator. The effects on the projections would be considerably more substantial by mid-1975. A shift from either the C to B or B to A money supply growth rates would add about $4 to $4-1/2 billion to real GNP and one- or two-tenths of a percentage point to the deflator, and would reduce the rate of unemployment by about two-tenths of a percentage point. In addition, perhaps three-tenths of a percentage point would be cut from the projected levels of interest rates. However, those differences did not appear large when one considered the great amount of uncertainty in the current situation. Indeed, it was quite possible that the basic projections were completely out of the ball park.

Mr. Mayo asked how the Chairman evaluated the likelihood of Congressional action on a Government expenditure ceiling. His own view was that it was now too late for action with respect to the budget for fiscal 1975 and perhaps too early with respect to that for fiscal 1976.

The Chairman expressed the view that the expenditure ceiling recently approved by the Senate of $295 billion--$10 billion below the budget submitted by the Administration earlier in the

year--would not be enacted into law. However, there was a possibility that the Administration would recommend a more moderate reduction in its budget proposal for fiscal 1975--perhaps on the order of $3 or $4 billion.

Mr. Brimmer noted that the green book projections called for housing starts to increase sharply in the third quarter--at an annual rate of over 27 per cent. He asked if the staff still held to that forecast, particularly in light of the decline in housing starts in May.

Mr. Partee replied that the staff undoubtedly would reduce that estimate if it were redoing the projections today. Not only were May housing starts, at 1,455,000 units, down 11 per cent from April, permits, at 1,055,000 units, were down 19 per cent. It was true that the May figures did not reflect the new Government housing program, which was announced on May 10, and thus might overstate the weakness in the industry. However, it was his impression from conversations with people in both the housing and savings industries that they were most concerned at the moment about the prospects for their own survival.

Mr. Brimmer said he also foresaw no great strength in the housing sector. Furthermore, it appeared that expenditures on

bu,iness fixed investment would be rising only slightly faster than prices, and that the path of real consumer expenditures would be nearly flat. The mainsprings of the growth in the economy expected over the next year were not clear to him. He also wondered whether the projected rate of unemployment might not be too low, given the prospective increase of more than one million in the civilian labor force over the next 12 months.

The Chairman remarked that Mr. Partee, in his statement, had emphasized that the projected recovery in economic activity was modest.

Mr. MacLaury referred to Mr. Partee's comment that the staff projections might be completely out of the ball park. The potential causes of a shortfall were obvious, and in his earlier statement Mr. Partee had suggested that the projections might be overly optimistic. He wondered, however, whether it was possible to spell out a scenario in which the recovery might turn out to be considerably stronger than projected, either in real terms or because of a new inflationary surge.

Mr. Partee said there was indeed a possibility that the rate of inflation would be greater than projected, resulting in a higher nominal GNP. Real growth in economic activity could

conceivably be higher than anticipated if, for example, there were a substantial reduction in oil prices. The oil-exporting countries had not given any indication of such a move in their current price discussions, but if oil prices did decline expectations would improve. A general decline in prices of internationally traded industrial commodities would have a similar effect, and a sizable rise in the stock market also could prove highly constructive. On the whole, however, it was difficult for him to construct a plausible rationale for a significantly higher rate of real economic growth than that projected in the green book. In suggesting that the projections might be out of the ball park he had had in mind potential shortfalls; specifically, he had been thinking of the potential impact of a constriction in financial markets.

Mr. Partee added that he did not want to sound too bearish. He wished to emphasize that sluggishness in the real economy and disturbances in financial markets were the price of maintaining a highly restrictive monetary policy. While the staff had incorporated some allowance for financial disturbances in its earlier projections of real GNP, it had found it necessary to lower the projections in recent months.

Mr. Black said he was somewhat puzzled that the projected rise in short-term interest rates over the remainder of 1974 was followed, in the staff estimates, by an accelerated growth in M_1 in the first half of 1975. He questioned why the expected rise in short-term rates would not be followed, after some lag, by a reduced rate of M_1 growth and wondered if the staff's projections implied some easing of policy late this year.

Mr. Partee replied that green book projections did not assume any easing in monetary policy; as usual, they were based on the assumption of no change in policy. The M_1 growth rate assumed for the remainder of 1974 was below the Committee's longer-run target rate in order to compensate for the overshoot of recent months. With that assumed rate of growth in the narrowly defined money stock, interest rates would continue to advance so long as the nominal GNP continued to rise at an annual rate of 8 or 9 per cent. The econometric model indicated that interest rates would continue to increase, under those assumptions, through 1975; there would be no turnaround in interest rates until such time as the economy might go into recession.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the

period May 21 through June 12, 1974, and a supplemental report covering the period June 13 through 17, 1974. 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:

> Open market operations over the period since the Committee last met were devoted to maintaining taut conditions in the money market in light of the behavior of the monetary aggregates; in the process, occasional market anticipations of easing in System policy and of a sharp decline in interest rates were disabused. Operations were affected by a pre-tax-date decline in Treasury balances at Reserve Banks, by alternating periods of stringency and ease in the money market as banks pursued erratic reserve management policies, by shifting expectations on the future of interest rates, and by changes in the technical position of the market.
>
> Given the short-run nature of most reserve shifts--together with dealers' desires to maintain relatively light positions--most operations took the form of temporary injections or withdrawals of reserves through matched-sale purchase transactions or repurchase agreements. Transactions were extremely large, with matched sale-purchase transactions totaling over $9 billion and RP's over $10 billion. Single-day transactions reached the $2-1/2 billion level on two occasions--one on each side; billion-dollar days were commonplace. Outright transactions included the purchase of $209 million of coupon issues in the market early in the period and a sale of $300 million of Treasury bills in the market on June 7. The latter sale was interpreted--correctly--in the street as a signal that the overbuoyant attitude in the market brought about by some modest decline in prime rates was not apt to be followed by an easier monetary policy as many had been fondly hoping. Other outright transactions were generally small and largely offsetting.

General market interest rates were surprisingly stable over the period, despite day-to-day fluctuations. In yesterday's regular Treasury bill auction average rates of just under 8.20 per cent were established for 3- and 6-month bills. The 3-month bill was virtually unchanged from the rate set in the auction just preceding the last meeting and the 6-month bill was down about 25 basis points from that level. While markets, on balance, put in a good performance, there was considerable unease, and by the close of the period sizable calendars of municipal and utility issues placed a substantial drag on the market.

While the general market performance has been good--given all the uncertainties--there have been a number of trouble spots that contribute to a substantial feeling of unrest in the markets. Rumors abound about various possible failures or the inability of some lesser known names to find financing at any price. The search by investors for quality instruments goes on, resulting in rate spreads in the commercial paper market between well-known and lesser-known names at unusually high levels. Great attention is being paid to downgrading of individual companies by the rating services. REIT's, mortgage bankers, and utility borrowers appear particularly affected. Investor doubts about the legality of commercial paper backed by bank letters of credit have created problems in that market, with many borrowers forced to go to the bank or banks involved. The Franklin National Bank problem still causes an element of unrest. Although the situation has stabilized somewhat, it could boil up again at any moment.

Despite the nervousness with respect to the viability of individual institutions, market participants have a strong desire to believe in declining interest rates and an imminent easing of monetary policy. Rumors of huge investment programs in the United States by oil-producing countries have added to market optimism from time to time. During the period, we have at least convinced the market that emergency loans--such as the one to Franklin--do not mean a loss of monetary control by the

> Federal Reserve; that open market operations can be used to offset any extra reserves that are supplied by such lending. Looking ahead, it appears clear that expectations are apt to be subject to severe movements in either direction and that we shall have to be alert to sudden changes in market sentiment in our day-to-day operations.
>
> As far as the Treasury is concerned, it was able to get through the pre-tax-date period without serious difficulty. Earlier, it appeared that the Treasury might have to engage in some emergency borrowing and we had dusted off some of our contingency planning for such borrowing through the Trading Desk. As noted earlier, the large movement in the Treasury balance at the Reserve Banks was a factor in our own large operations. The variability of the Treasury balance has in general been a factor that, over time, has complicated open market operations. Treasury sensitivity to running high balances in tax and loan accounts has been the major factor at work. In this regard, the Treasury is in the process of completing plans for earning interest on some part of its tax and loan accounts. Once they are in place, this sensitivity should be reduced and we may be able to keep the Treasury balance at the Reserve Banks at a more normal--and stable--level. Finally, there is some uncertainty at the Treasury whether the proposed debt ceiling legislation will be passed without the addition of unacceptable amendments. The Treasury is thus doing some contingency planning--including the pinpointing of dangerous dates--to determine what alternative approaches are available to it if suitable legislation is not passed.

Mr. MacLaury noted that he had heard rumors from time to time that oil-producing countries would be permitted to invest their revenues in special Treasury securities. He asked whether those rumors were well-founded.

In reply, Mr. Holmes observed that, according to a news report yesterday, such investments would be made at a rate of $10 billion a year. He had not been able to learn from the Treasury whether the report was correct.

Chairman Burns remarked that discussions regarding such investments were going forward.

Mr. Holmes said he might mention in that connection that earlier today the Desk had received an order from an oil-producing country for the purchase of $500 million of Treasury bills for cash. In view of the scarcity of bills in the market, he anticipated some difficulties in executing the order.

In reply to a question by Mr. Black concerning the state of interest rate expectations, Mr. Holmes commented that there appeared to be a strong--and strange--desire in the market to believe that rates had peaked; that long-term rates in particular would stabilize and then decline. Much investment advice was being offered to the effect that this was a good time to buy fixed-income securities. While such attitudes might well strengthen, there also were some negative factors in the market. He thought market attitudes over the next several weeks would be characterized by a high degree of uncertainty; it would be necessary to remain alert to changes in sentiment, which might be in either direction. The $500 million

bill order he had mentioned could, in itself, have some effect on market conditions, and it had to be handled carefully.

Chairman Burns asked whether the Desk felt obliged to execute foreign official orders even when doing so appeared likely to disrupt the market.

Mr. Holmes replied that the Desk tried to execute the orders in a nondisruptive manner. In the present case, the Desk probably would carry out part of the bill purchase order for cash today, and place the rest of the funds in short-term repurchase agreements. Dealers would have a supply of this week's new bills on Thursday; on that day, or beginning then and continuing on subsequent days, the funds initially placed in repurchase agreements could be shifted into bills.

The Chairman then asked whether the Desk was prepared to offer investment advice to foreign official institutions from which it had received transaction orders.

Mr. Holmes replied that the Desk ordinarily limited itself to executing orders, as a service to the foreign institutions. However, because the particular central bank that had placed the order in question had not had much experience in handling large sums, some preliminary discussions of alternative possible investments would have been desirable. Unfortunately, there had been

no advance notice of the order. Because it was a cash order to be executed today, the Desk planned to carry it out--in a manner designed to minimize its market impact--and to hold discussions with the foreign institution as soon as feasible with regard to possible future investments.

Chairman Burns remarked that such discussions were highly desirable in connection with investments by any country that had had little experience in managing large sums.

Mr. Debs observed that, as the members knew, officials of the New York Bank had been holding such discussions with financial officers of many of the oil-producing countries. As it happened, the country in question had not been included in the group, and their order had come as a surprise. He hoped it would prove possible to avoid such surprises in the future by establishing good lines of communication with all of the major oil producers. While the size of the current order created difficulties under the circumstances of the moment, it had been stressed in conversations with oil-producing countries that one of the attractions of the U.S. Government securities market was its capacity to absorb very large investments.

The Chairman noted that some commercial bankers were no longer accepting short-term deposits as readily as previously; they

were beginning to react selectively and to offer counseling to depositors. As far as the Federal Reserve was concerned, there were questions of policy to which thought should be given by people at the New York Bank and in the System generally. While there were advantages in being able to execute an order of any size, some of the forces at work were potentially disruptive.

Mr. Holmes noted that the Desk had been talking with the Treasury about various means that might be used to cope with large lump-sum investments, such as initially placing such funds in special Treasury issues and then gradually shifting them into Treasury bills. He thought such a procedure might work quite smoothly.

In response to a question by Mr. Mitchell, Mr. Holmes observed that the central banks of some oil-producing countries preferred to make their investments in the U.S. market through commercial banks. However, many central banks preferred to work with the Federal Reserve because of the advantages they saw in having a single point of contact.

Mr. Mitchell remarked that there presumably was some level below which the Treasury bill rate could not decline without impeding the System's ability to maintain its restrictive posture. He asked whether Mr. Holmes thought that as a result of foreign official

investments the 3-month bill rate might decline in the near term from its present level of roughly 8 per cent to the neighborhood of 6 per cent.

Mr. Holmes replied that that struck him as unlikely. If the bill rate did fall to 6 per cent it probably would not stay there very long.

Mr. Morris said it was his impression that the Treasury bill rate no longer was the financial barometer it used to be.

Mr. Holmes agreed. He added that bill rates recently had been out of line with other market rates partly because Treasury bills were the kind of high quality investment many investors had been seeking and partly because foreign central banks had been buying sizable amounts of bills.

Mr. Morris then remarked that he would expect no adverse psychological reaction to low bill rates, so long as the market understood the special reasons for them.

Mr. Holmes observed that the major problem was likely to be a highly erratic bill market. Rates would decline in the face of strong demands; subsequently, when the demands had abated and supplies came into the market, dealers would be reluctant to acquire bills because of the wide spread between their yields and financing costs, and bill rates would tend to move up sharply.

Mr. Holland expressed the view that even if bill rates fell to 5 per cent, none of the bite of monetary restraint would be lost so long as private short-term market rates remained at their present levels.

Mr. Mitchell noted that declining bill rates could lead to reductions in other short-term market rates as a result of market arbitrage. He added that a commercial bank from which a foreign official institution sought to buy CD's had an opportunity to negotiate regarding the rate to be paid. He was disturbed that the System had no corresponding opportunity to negotiate on rates when it received a foreign official order to buy bills.

Mr. Axilrod remarked that a sharp decline in bill rates as a result of special factors might produce some temporary declines in other short-term rates. If, however, the Federal funds rate was kept high and there was no fundamental change in expectations regarding the economic outlook, the other short-term rates--and the bill rate itself--would soon tend to move back up. Altogether, such rate fluctuations might run their course within a 2-week period.

In response to a further question by Mr. Mitchell, Mr. Holmes observed that when a foreign official institution proposed to invest an unusually large sum in Treasury bills, it was the Desk's

practice to suggest diversification and to work out an investment program for the institution that might include special Treasury securities and perhaps CD's.

Chairman Burns asked about the maturities of the special Treasury issues Mr. Holmes had mentioned.

Mr. Holmes replied that the maturities varied according to the desires of the foreign institutions. It was his impression that most of the Arab oil-producing countries preferred to start off with short-term issues. However, they probably would be willing later to shift to longer-term securities.

The Chairman commented that investments in long-term issues would be in the interest of those countries, of the United States, and of the international financial system generally.

Mr. Wallich expressed the view that the oil-producing countries were testing the relative merits of the U.S. and Euro-dollar markets as investment outlets. He thought it would be desirable to accommodate them in the U.S. market, so long as that did not interfere with the maintenance of orderly market conditions or with the objectives of domestic monetary policy.

Mr. Debs remarked that the New York Reserve Bank people were stressing the desirability of both diversification and long-term

investment in their conversations with financial officials of Arab oil-producing countries. Such discussions had not yet been held with the officials of a number of such countries, but would be soon. He might note that the discussions were extremely difficult, both because of physical communications problems and because of their lack of experience in handling large sums. They did not always make their decisions on the bases that U.S. investors would; in particular, the rate of return often was not a primary consideration.

Mr. Brimmer noted that the System had traditionally encouraged central banks and other official bodies to deal with official bodies in this country. For example, during a trip to Latin America this spring, he--along with Mr. Hayes and other members of the party--had sought to persuade officials in countries with funds to invest to look to the Federal Reserve for assistance; Mr. Debs had done the same on his recent visit to the Middle East. He hoped that the System would not, because of tactical considerations, change the basic thrust of that policy and instruct the Manager to try to divert foreign central bank investments to the private market. He agreed with Mr. Wallich that it would be desirable to accommodate the investment desires of the oil-producing countries, making whatever offsetting adjustments might be required. The Manager would need a certain degree of flexibility, and it might be necessary

for the Treasury to devise some new investment instruments. He hoped the Committee would focus on the basic policy issue, and leave the technical and tactical questions to those with day-to-day responsibility for them.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 21 through June 17, 1974, were approved, ratified, and confirmed.

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

> Of the alternatives presented in the blue book, alternative C represents a continuation into the fourth quarter of the 5-1/2 per cent, 6-month growth path adopted for M_1 by the Committee at its last meeting. To get on such a path, given the 7 per cent increase in M_1 of the second quarter, requires a 4-3/4 per cent annual rate of growth in M_1 between now and year-end. We expect that such a longer-run target would be accompanied by a rise in the Federal funds rate to a consistent trading range around 12 to 12-1/4 per cent and by higher market interest rates than currently prevail, assuming the GNP projection is correct and that GNP doesn't turn out to be weaker than is projected. This is essentially the same interest rate outlook as presented at the time of the last meeting for such a growth path.
>
> The staff's estimate of the likely longer-run effect on the aggregates of maintaining currently prevailing money market conditions--that is, an 11-1/2 to 11-3/4 per cent Federal funds rate--is shown by alternative B. We expect that M_1 growth would be at around a 5-3/4 per cent annual rate between now and year-end under that assumption. Thus, this alternative does not contemplate an effort to compensate for the 7 per cent second-quarter growth, but does moderate longer-run

growth as compared with actual experience in the first half of 1974. Inflows of consumer-type time and savings deposits to banks and thrift institutions would remain under constraint, but pressures on institutions from that source would not be significantly greater than in recent months.

Alternative A is the alternative that contemplates some easing of money market conditions, continuation of growth rates in M_1 close to those of recent months, and some pick-up of net savings inflows to thrift institutions. Because of the sensitivity of market expectations at the moment, a significant easing in the funds rate, particularly to the 10-3/4 per cent mid-point of the range for this alternative, would likely be followed by a sharp drop in market interest rates generally. Declines might be especially sharp in the Treasury bill market, where shortages in the floating market supply of securities remain and from Mr. Holmes' report appear likely to get larger. Interest rates would likely come back up some as time went on, however, assuming maintenance of the still relatively high funds rate.

I was going to add, Mr. Chairman that the 6-month monetary targets, and associated interest rates, of alternative C--the most restrictive of the alternatives--are judged to be generally consistent with the green book projection of GNP for the latter part of this year and early 1975; in response to Mr. Holland's question this has already been discussed to some extent. I would just add the final point, which I believe was brought out, that this assumes that a somewhat more rapid growth in the aggregates is permitted by early 1975.

Mr. Brimmer noted that at the time of the Committee's previous meeting there had been considerable concern about the vulnerability of financial institutions other than Franklin National. He asked whether Mr. Axilrod thought there were grounds for equal concern at this time.

In reply, Mr. Axilrod said he thought that developments over the past month had indicated that the Franklin situation had been contained. In his view, thrift institutions and commercial banks generally were in a relatively good position to sustain for a while the current degree of tightness, and perhaps a bit more. While he could not assert that there would not be one or two additional instances in which banks or other financial institutions found themselves in troublesome situations, he was somewhat less concerned about the risk of generalized difficulties than he had been a month ago.

Mr. MacLaury asked whether it would be reasonable to associate a preference for the short-run operating ranges of alternative B or A with a preference for the longer-run aggregate targets of alternative C, or whether consistency would require a member favoring the B or A short-run ranges to advocate longer-run targets higher than those of C.

Mr. Axilrod noted that the longer-run targets shown in the blue book applied to the period ending in December, roughly 6 months from now. In reestimating the equations of its money market model recently, the staff had found somewhat shorter lags in the response of money demand to interest rate changes than indicated by the earlier equations. The implication, in his

judgment, was that the Committee could delay a bit in moving to the firmer money market conditions called for under alternative C and still expect to achieve the alternative C growth rates over the 6-month period as a whole.

Chairman Burns then called for the Committee's discussion of monetary policy and the directive.

Mr. Leonard remarked that, even though he was more bullish on the economy than some people around the table, he favored the specifications for the aggregates shown under alternative B rather than those of C. He noted that the level of M_1 now estimated for June--$281 billion--was $3 billion higher than the figure consistent with the growth path the Committee had agreed upon in February. Including that June estimate, growth in the money stock on a quarterly average basis had been at an annual rate of about 9 per cent from the first to the second quarter, and about 8 per cent over the first half of the year. He believed that everyone present would have preferred a lower June level and lower growth rates in the second quarter and the first half. That, however, was spilt milk; and having spilt the milk, he thought the Committee should not try to sop it up too quickly. Overzealousness in attempting to get M_1 growth back on target could have some undesirable effects on the real economy.

Mr. Leonard observed that the longer-run targets shown under alternative C implied a growth rate in M_1 of only about 5 per cent for the second half and less than that for the fourth quarter. The alternative B targets, which he preferred, would yield a growth rate of about 6 per cent for the second half. For the year as a whole, the growth rate would be 7 per cent, the same as the trend rate established over the three previous years. Such growth was too rapid for the long run since it would maintain the trend rate of inflation. As he had indicated, however, too quick a deceleration was likely to harm the economy.

While he favored the alternative B targets for the aggregates, Mr. Leonard remarked, he did not believe they could be achieved with the range of tolerance for the funds rate shown under B--namely, 10-3/4 to 12-1/4 per cent. Those figures appeared high in an absolute nominal sense, but he thought they were low relative to those that would be consistent with the desired growth rates.

Mr. Eastburn said the question facing the Committee was how far it could go in getting the aggregates under control in light of the delicate state of financial markets. In his view, the Committee should go as far as it could without precipitating a liquidity crisis. Such a course might sound like brinksmanship,

and perhaps it was; certainly it carried risks. However, he believed it was fairly important to take effective action to reduce the rate of growth in the aggregates.

To explain his reasoning, Mr. Eastburn continued, he might note the indications in the green book that the outlook for inflation was now even worse than it had appeared earlier. Over the first 5 months of 1974 M_1 had grown at an annual rate of 7 per cent, the same as the average rate prevailing over the three preceding calendar years. That was too high a growth rate, and it had come about because the Committee had been unwilling to adhere to its long-run growth targets in the face of short-run developments in credit markets.

Mr. Eastburn expressed the view that the excessive rate of growth in the monetary aggregates had not only helped to make possible the recent rate of inflation but had also contributed to the precarious state of financial markets. There had been a tendency to try to keep financial conditions from deteriorating by means that added to prevailing inflationary pressures--a course that could be self-defeating. In a real sense, the most fundamental solution to the problem of financial instability was to be sought in a persistent effort to get inflation under control by achieving a more moderate rate of growth in the aggregates.

Mr. Eastburn observed that those considerations led him to favor the longer-run targets shown under alternative C. He favored the upper limits of the 2-month ranges for the aggregates shown under C, but he would reduce the lower limits by 1 or 1-1/2 percentage points in order to take advantage of any unexpected weakness in the aggregates that might develop in the short run. With respect to the Federal funds rate constraint, he would set the upper limit at 12-1/4 per cent. Given the present sensitive state of financial markets, he would want the Desk to permit the funds rate to approach that limit only if necessary, and then very cautiously--moving up by, perhaps, one-eighth of a percentate point per week.

Mr. Bucher remarked that, since he and Mr. Leonard had had some policy differences in the recent past, he was particularly pleased to say that he agreed with the latter's general conclusions on policy today. Indeed, he would like to memorialize a statement Mr. Leonard made earlier, which deserved emphasis; speaking of a 5-1/2 per cent target for M_1 growth over the rest of 1974, Mr. Leonard had said that could not be accomplished "without throwing the economy into a tailspin." He concurred wholeheartedly in that statement.

In his judgment, Mr. Bucher continued, the Committee had to proceed with great caution. It was walking on eggs, and some

cracks were showing--in the housing industry, in financial markets, and in the areas of REIT's and some public utilities. With respect to the economic outlook, he was concerned about the increases that were projected in the unemployment rate even after optimistic assumptions were made about the impact of an expanded public employment program. Although he continued to question whether monetary policy alone offered a practical answer to wage-price inflation, in light of the distance the Committee had already gone he would favor holding fast for the time being. But he would also urge the Committee to be ready to change direction if it began to receive signals suggesting a major downturn. He found the specifications of alternative B acceptable, and he differed with Mr. Leonard only in that he favored the range for the funds rate shown under that alternative.

Mr. Clay said he thought there was a lesson for the Committee in his own youthful experience with an air rifle that lacked a sight adjustment. On finding that his shots were consistently hitting high and to the left, he had attempted to compensate by repeatedly moving the target in that direction. When there was no room left to move the target, he had finally learned that the way to hit it was to aim low and to the right. The Committee had been overshooting its target for the monetary

aggregates over a long period, and it had been responding by raising the target. He could detect very little difference in economic conditions from those of a month ago, and he would not want to aim for a higher growth path now than that adopted then.

Mr. Clay recommended that the Committee's targets for the aggregates be indexed by an M_1 growth rate of 4-3/4 per cent over the last 6 months of the year, as called for under alternative C. For the near term, that would require some tightening of money market conditions, with Federal funds trading in a range of 11-1/2 to 13 per cent. He might note that that prescription also implied a growth rate in M_1 of 6 per cent for 1974 as a whole, which was about the same rate as achieved last year. In contrast, alternative B implied an M_1 growth rate of 6-1/2 per cent for 1974, despite recent evidence of accelerating industrial commodity prices and wage settlements. In his judgment, therefore, it was imperative that monetary policy be no easier than suggested by alternative C. He would point out that the dangers involved in continuing or accelerating inflation were as great, or greater, than those involved in some slowing of the economic growth rate.

Mr. Coldwell noted that he also had had some youthful experience with poor quality rifles, and recalled that they not only shot badly but also sometimes had rough kickbacks. In light

of the problem of inflation, he had advocated gradual increases in monetary restraint over recent months. Now, however, he would favor holding steady; conditions in financial markets, and perhaps other considerations as well, argued against adding to the existing degree of restraint. He would prefer a directive couched in terms of money market conditions, like that adopted at the previous meeting, to any of the alternatives distributed by the staff,[1/] which focused on the monetary aggregates. He would choose specifications somewhere between those shown under alternatives B and C, in the hope of achieving the best of both worlds and of avoiding too much upward pressure on interest rates. While he was not enough of a forecaster to be confident about the direction interest rates would take, he would note that rates as a whole had shown some stabilizing tendencies over the past 6 weeks. He might also mention that he had detected a new note of caution in the comments of businessmen with whom he had talked recently. Those businessmen were not unhappy with their present volume of activity; they were doing quite well. In looking to the future, however, they were concerned about the cost of money and especially about the problems of raising capital funds.

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

Mr. Coldwell added that he would be inclined to widen the 2-month ranges specified for the aggregates by reducing the lower limits, in order to accommodate somewhat lower growth rates than expected, should they develop. For the Federal funds rate, he would set a range of 10-3/4 to 12 per cent.

Chairman Burns said he might comment at this point, since his views in some respects were quite similar to Mr. Coldwell's. A good deal of restraint had been built into financial market conditions, and he would be hesitant at the present time about a significant further tightening. In his opinion, financial markets were still in a highly nervous state.

The Chairman remarked that he might offer specifications for the members' consideration that were somewhat more specific, and differed a bit, from those proposed by Mr. Coldwell. For the longer-run targets for the growth rates in the aggregates, he would suggest figures at the midpoints of those shown in the blue book under alternatives B and C--namely, growth rates over the second half of the year of 5-1/4 per cent for M_1, 6 per cent for M_2, and 9-1/4 per cent for the bank credit proxy. For the June-July ranges, he would retain the upper limits shown under alternative C, but would reduce the lower limits; the ranges would be 10 to 13-1/2 per cent for RPD's, 3-1/2 to 7-1/2 per cent for M_1, and

5-1/2 to 8-1/2 per cent for M_2. For the funds rate, he would set a range that was fairly narrow, but not as narrow as the half-point range adopted at the previous meeting--which, incidentally, the Committee had decided to widen to three-fourths of a point in the inter-meeting period. The range he had in mind was 11 to 12 per cent.

Mr. Holland said he suspected that virtually everyone around the table would agree that monetary policy had to stay tight in the interest of contributing what it could to slow the present inflation. There were questions of semantics and of techniques, however, in deciding how to define "tightening" and how to go about staying tight.

Personally, Mr. Holland continued, he was impressed by what seemed to him to be growing signs of the bite of monetary restraint. He found such signs in the red book and in the comments of businessmen and bankers with whom he had talked. In his judgment, M_1 was not an exclusive--or reliable--indicator of the degree of monetary restraint at the moment. M_1 was an important magnitude that carried meaning, but M_2 and M_3 also were significant magnitudes. He was impressed by the recent slowdown in those series--particularly by the slowing in M_3, because of its implications for the availability of housing credit and for the level of unused resources in the

construction industry. He also was impressed by the widespread reports of tightened loan policies at banks and other lending institutions, and by the signs of cautiousness and heightened desires for liquidity on the part of many savers and investors. All of those developments were elements of the process through which monetary restraint worked to dampen economic activity, and through which it might eventually provide help in combatting inflation. Concurrently, questions were arising about the condition of individual financial institutions which should serve as a warning to the System not to press too far.

Mr. Holland observed that he would like to maintain about the current degree of tension on money market conditions, because he believed such a course would result in a gradual slowing in M_1, and perhaps in a little more slowing in M_2 and M_3 than had occurred recently. That was approximately the amount of restraint he thought the economy should be expected to absorb. Accordingly, he favored specifications about like those shown under alternative B. He would be agreeable to reducing the lower limits of the 2-month ranges for the monetary aggregates by 1 percentage point, in order to take advantage of unforeseen weakness to that extent. He liked the 11 to 12 per cent range the Chairman had proposed for the Federal funds rate--not because he was necessarily opposed to

funds rates below 11 or above 12 per cent, but because he thought financial market conditions were in a delicate enough state to warrant a last-minute review of the situation before a decision was made to move outside that range. The Chairman might well want to recommend a modification of the limits on the funds rate in the coming inter-meeting period after taking account of all circumstances, including the probable effects on market expectations of funds rates below 11 or above 12 per cent. With respect to the directive, he had a slight preference for retaining the language calling for maintenance of about the prevailing restrictive money market conditions so long as the aggregates remained within acceptable ranges. However, he also would be quite comfortable with the language of alternative B as drafted by the staff.

Mr. Winn remarked that while he shared the view that the Federal Reserve should maintain both the appearance and the fact of monetary restraint, he was beginning to be disturbed by the levels to which interest rates were climbing. That raised the question in his mind of whether the System might not consider action on the discount rate as an alternative to running the funds rate up still further. Discount rate action would convey a message and have an impact on psychology but would avoid the bite that would be inherent in further increases in the funds rate.

A second point, Mr. Winn continued, related to his belief that an extreme form of the domino theory underlay much of the concern about the problems that might arise for individual financial institutions. He wondered whether the domino theory had any more validity in the financial area than in the international political area. In particular, he wondered whether it might not be better to run the risk of failure of one or two financial institutions, rather than easing off enough to prevent such failures and in the process increasing the rate of inflation. He was willing to maintain the monetary restraint needed to accomplish the Committee's objectives even at the price of the failure of an institution or two, because he had no real fear that such failures would cumulate into a general financial collapse.

Mr. Kimbrel noted that he had participated in the daily conference call since the last meeting and found that the Desk had done its usual commendable job under the difficult circumstances with which it was confronted in that period. While some slowing in M_1 finally became apparent in May, businessmen in the Sixth District still seemed very much concerned about the possibility of renewed inflation and were inclined to question whether the Federal Reserve was indeed prepared to hold to its course long enough to accomplish the restraint it sought. He could not

recall a time when there was such widespread support for monetary restraint; even some of those on whom the burden fell most heavily were still saying that the System had no alternative but to continue its present policy. He hoped that nothing the Committee did today would appear as a relaxation of that policy.

Mr. Kimbrel said all of the specifications the Chairman had suggested were agreeable to him except perhaps the range for the funds rate. In the absence of some unusual circumstances, he would prefer a lower limit for that range of not less than 11-1/4 per cent. A decline in the funds rate much below that level was likely to be interpreted by observers as the kind of signal of a policy change that he hoped would be avoided in the coming period. He would suggest that the upper limit be set at 12-1/4 per cent, on the understanding that the rate would be permitted to move up to that level only if necessary.

Chairman Burns observed that he would see no problem in setting the lower limit at 11-1/4 per cent. He did have a little difficulty with respect to an upper limit above 12 per cent, however, since he thought it would be desirable to review the situation before aiming for a rate that high.

The Chairman then asked Mr. Partee for his policy recommendations.

Mr. Partee said it was worth noting that the Committee had set a very difficult objective for itself at the beginning of 1974--that of trying to restrain monetary growth in a highly inflationary environment, in which transactions demands for money were rising sharply. During the first 4 months of the year the consumer price index increased at a 12 per cent annual rate, and during the first 5 months the wholesale price index rose at an 18 per cent rate. It was regrettable that the M_1 growth rate, at about 7 per cent, had overshot the Committee's target by roughly one percentage point, but that nevertheless constituted an excellent performance.

Mr. Partee remarked that Mr. Clay's analogy about targets struck him as defective in one respect. The Committee's fundamental target was the economy, not the money supply; the latter was analogous to the sights on the rifle rather than to the bull's eye. While analysts might differ as to whether the growth rate in real GNP in the coming period would be zero or 1 or 2 or 3 per cent, no one argued that the economy was strong or that a boom in business lay ahead.

In concluding, Mr. Partee said he would describe the current objective of policy as that of keeping the pressure off real commodity markets for the foreseeable future. In his judgment, the Committee had already gone far toward assuring that result. He

thought, therefore, that it could afford to be a bit tolerant of the recent overshoot in the money supply.

Chairman Burns said he had interpreted Mr. Partee's earlier statement to suggest that the absence of any great expansive thrust in the economy was, by and large, a good thing--that an economic boom would be highly troublesome under present conditions, and a mild growth rate was to be preferred to a rapid one. He asked whether that interpretation was correct.

Mr. Partee replied that it was. In his view, the desired rate of growth in real GNP was below 4 per cent, but above zero. While the projections suggested that growth would be in that range in coming quarters, the risks of misses were mainly on the low side. It was with that outlook in mind that he believed the Committee could be tolerant of recent M_1 growth rates. It also could afford to give due regard to financial markets, which were still quite uncertain and subject to shock, by maintaining the funds rate in about its present range. He agreed with the Chairman's recommendations.

Mr. Debs said he favored the specifications suggested by the Chairman except that, like Mr. Kimbrel, he would prefer a slightly higher range for the Federal funds rate. In view of the long-run goal of bringing inflation under control, if the Committee were to focus solely on the aggregates it no doubt should choose alternative C with all of its specifications in an effort to get

back on target over the rest of the year. However, in light of the present sensitive state of financial markets, the Committee could not focus solely on the aggregates but must also look to market conditions. In the circumstances, he would not want to adopt the 11-1/2 to 13 per cent range for the funds rate shown under C. He did not believe there had been a basic improvement in the markets since the last Committee meeting; conditions were quieter on the surface, but events simmering just below the surface could erupt at any moment and a sharp rise in the funds rate could have extremely adverse consequences. That argued for focusing primarily on the funds rate and establishing a somewhat narrower range than customary for it.

In considering the specific range to be adopted, Mr. Debs noted that the funds rate was currently about 11-3/4 per cent. He would not want to see the weekly average rate drop below 11-1/4 per cent and thought that figure was reasonable as a lower limit. While a 12 per cent ceiling might give the Manager adequate scope for operations for a while, he would prefer to set a higher ceiling, perhaps at 12-1/4 per cent. In any case, it would be desirable for the members to maintain a particularly close surveillance over market conditions and Desk operations during the coming period and to stand ready to modify the instructions.

As to the directive, Mr. Debs said he could accept either the customary formulation in terms of growth rates in the aggregates

or language focusing on money market conditions similar to that adopted at the last meeting. In the present circumstances, the practical difference between them was not great, especially since the latter included a proviso relating to aggregate growth rates.

Mr. Brimmer said he concurred in Mr. Partee's conclusions. In particular, he would want to aim for a longer-term growth rate in real GNP that was below the trend rate but above zero. He hoped the growth rate would not be permitted to fall below zero, and he noted that the margin above zero in the staff's projections was rather thin. It should also be kept in mind that the main effects of the policy decision taken now would be felt in 1975 and not 1974.

On balance, Mr. Brimmer observed, the specifications suggested by the Chairman appeared appropriate to him, except that he would favor a 11-1/4 to 12-1/4 per cent range for the Federal funds rate. Like others, he thought the members should be alert to the possible need to change instructions during the inter-meeting period.

Mr. Brimmer added that it was important for everyone in the Federal Reserve System to distinguish sharply between the objectives of maintaining reasonable liquidity in the economy and of rescuing every financial institution that got into trouble. While the System

had not adopted the latter objective, many observers unfortunately thought it had. He hoped that System people would take advantage of every opportunity to clarify the distinction.

Mr. Balles noted that there had now been roughly 6 months of double-digit inflation. The prospects for getting inflation under control were rather discouraging, particularly after the sharp rise in the wholesale price index in May. He continued to believe that inflationary expectations represented the greatest long-run threat to the economy; the forces such expectations set in motion could lead to a great deal of instability and erratic behavior.

Mr. Balles said he had received the impression from staff comments today that financial market conditions had been tranquilized to some extent over the past month. If that was so, the Committee had a little more flexibility now in its efforts to get the aggregates under control. He noted that even if the alternative C growth rates were achieved, M_1 would increase between the fourth quarters of 1974 and 1975 by 6.6 per cent; the alternative B growth rates would result in a 7 per cent rise over that period. To his mind both growth rates were probably too high to begin to contain inflationary pressures over the longer run. Nevertheless, in view of the sensitive state of financial markets, he was prepared to

accept the Chairman's compromise proposals with respect to targets for the aggregates. Like several others, however, he would favor a funds rate range of 11-1/4 to 12-1/4 per cent.

Mr. Balles said he might add one further observation. Over the weekend he had participated in a program along with Congressman Ullman of Oregon, who was the ranking majority member of the House Ways and Means Committee, after Chairman Mills. Congressman Ullman had stated in his opening remarks that he was totally opposed to the present high interest rate policy. However, he had gone on to say that the Federal Reserve really had no choice; that with fiscal policy making no contribution to combatting the extremely serious problem of rampant inflation, he had reluctantly concluded that the Federal Reserve was following the right course. Both in his speech and in a private discussion afterwards, Congressman Ullman had implied that that point of view had considerable support in the Congress.

Mr. Balles expressed the hope that the Committee members would not underestimate the extent of Congressional support for its present posture. He thought a majority of the Congress would concur in the System's efforts not only to slow the actual rate of price advance but also to dampen inflationary expectations.

Chairman Burns said he might offer his appraisal of the existing support for current Federal Reserve policy. He agreed that the support in the Congress was strong; he had been receiving almost no critical mail from that source. Of the letters that reached his desk from individuals across the country, a majority were still commendatory. The number of critical letters had multiplied, however, so that the ratio of favorable to unfavorable views had fallen somewhat.

Mr. Mayo said he subscribed to the general tone of Mr. Partee's comments on policy. While the Committee obviously had not done a perfect job, nor even as much as it had hoped, it had done a respectable job in applying as much monetary restraint as it could this year in the circumstances that it had found. He also subscribed to the point that had been made about the need for care in talking about rescue operations for financial institutions in trouble. In his view, such operations were appropriate for solvent institutions experiencing a temporary liquidity problem. It might well be that some other institutions would fall by the wayside, but that would not be unexpected so long as one believed in a profit and loss system.

With respect to specifications, Mr. Mayo remarked that he would have no difficulty in accepting the 11 to 12 per cent range

the Chairman had suggested for the funds rate. He thought there was merit in the case for a 12-1/4 per cent upper limit, however, and that also would be acceptable to him. He concurred in the Chairman's view that the 2-month ranges for the aggregates should be wider than those shown under any of the alternatives in the blue book. He thought the Committee had been making its task unduly hard by setting narrow ranges, and he would not mind widening the ranges still further, perhaps by a half point on either side. As to the longer-run targets, he would not be disturbed if the 6-month growth rate for M_1 were set at 5-3/4 per cent, as under B, rather than at the 5-1/4 per cent midpoint of B and C, as suggested by the Chairman.

Mr. Mayo noted that the directors of the Chicago Reserve Bank had been suggesting to him that a further increase in the discount rate might be appropriate soon. They were inclined to the view that it would be useful to signal that policy had been tightened another notch. While he was aware that others shared that view, he personally did not believe such a signal would be desirable at this point. In any case, his directors would be very restive about the present discount rate if the funds rate moved above 12 per cent.

In concluding, Mr. Mayo expressed a preference for a directive like that issued in May, which called for maintaining the prevailing restrictive money market conditions subject to a proviso relating to the aggregates. He thought that type of formulation was appropriate under present circumstances.

Mr. MacLaury said he would support the compromise specifications suggested by the Chairman. In view of his position at other recent meetings of the Committee, it should come as no surprise that he would prefer a slightly lower ceiling for the funds rate than the Chairman had proposed--specifically, he favored a range of 11 to 11-3/4 per cent--but he did not feel strongly on the point. In general, he believed the Committee was being forced by circumstances to choose between recession on the one hand and a totally unacceptable rate of inflation, which could lead to collapse, on the other hand. Given such a choice, he was prepared to maintain prevailing money market conditions, even though he recognized that such a course probably would make a recession--on his definition, at least--likely and perhaps unavoidable.

Because he held such views, Mr. MacLaury continued, he wondered whether it would not be desirable for the Committee to move outside the narrow bounds of monetary policy to advocate

measures in other areas. He had in mind, for example, speaking out in support of the Administration's proposals for supplementary unemployment benefits and for a public employment program. Such measures would be desirable on humanitarian grounds and also on economic grounds, in the sense that they would extend the period in which the System could maintain a restrictive stance. Similarly, while he agreed with the view that it was not the function of the Federal Reserve to save every existing financial institution, he thought it should be made clear that the System was prepared, as Mr. Mayo had suggested, to provide liquidity for solvent institutions. The System should also try to insure that any institution which failed to survive as a corporate entity did not collapse in a way that led to a loss of confidence in financial institutions generally. He realized that that was easier to say than it might be to accomplish.

Mr. MacLaury noted that another possible means of helping maintain confidence might be to supplement the System's restraint on growth in the aggregates by some sort of marginal capital ratios or marginal liquidity ratios for financial institutions--in effect, saying to those institutions that if they wanted to expand earning assets by a given amount, they would have to set aside some percentage of that amount in liquid form. He had not thought through

that possibility and did not know what the correct timing might be, but he would be interested in learning whether the staff had looked or would look into measures of that type.

Finally, Mr. MacLaury observed, with respect to the international area, he thought too much emphasis had been placed on recycling oil money, and that the initial reaction of the Administration and of Chairman Burns--to the effect that the only sustainable solution was to get oil prices down--was the correct one. He did not know whether the United States had any bargaining counters that could be used to bring about a reduction in oil prices. Whatever the outcome on that score, it would be desirable to continue the effort to have oil revenues invested in this country placed in longer-term securities or in equities and direct investments, rather than in short-term securities, so that the risks would be borne by the oil producers rather than by domestic financial institutions.

Chairman Burns observed that he had found Mr. MacLaury's comments to be exceptionally interesting.

Mr. Black remarked that much of what he had planned to say had already been said by other speakers, including Mr. Partee. One point that had not been made explicitly--although Mr. Mayo may have had

it in mind--was that it might be desirable at this time not to set targets, as such, for the aggregates but to think rather in terms of outer limits that the Committee could accept in the interest of reducing the risk of serious financial disorders. He believed that under present circumstances the main emphasis should be placed on money market conditions, and he favored retaining the wording of the previous directive. The specifications the Chairman had suggested appeared reasonable to him. However, he would be inclined to adopt an 11-1/4 to 12-1/4 range for the Federal funds rate, on the understanding that there would be some reluctance to aim for a rate above 12 per cent.

Mr. Wallich remarked that the Committee was operating under a two-fold constraint, one relating to financial markets and the other to the real economy. The financial market constraint involved the level of the Federal funds rate; his inclination was to permit increases in that rate to the extent the markets could tolerate. Since the System had available to it some means for helping to avoid institutional failures, he saw no reason for permitting the funds rate to drop to levels that would lead to excessive growth in the money supply.

The real sector constraint involved the growth rate of money, Mr. Wallich observed. He agreed with Mr. Partee's view that the Committee had achieved a good deal in that area, particularly

since the projected rate of growth in real GNP was lower than he thought desirable. The country was prepared to accept a certain amount of economic slack in the effort to combat inflation, and the amount that was tolerable would be greater if it developed gradually. It might well turn out that an inflation of the present type could not be ended without a recession, but the System certainly had to try; accordingly, he would favor aiming for a growth rate in real GNP of 2 or 3 per cent. While he recognized that it might not be possible to fine tune to that extent, he would not want to restrain the real sector any more than that.

With respect to specifications, Mr. Wallich continued, a growth rate for M_1 of 6 to 8 per cent for the immediate future was acceptable, although he would prefer growth toward the lower rather than the higher end of that range. He would not be inclined to raise the longer-run targets. Unless there were serious disturbances in financial markets that could not be dealt with by direct means, a funds rate near the present level should be taken as the minimum and the rate should be permitted to rise to levels that were realistic in terms of the objectives for money supply growth. It made no sense to continue hoping that restraint on growth in the money supply would be consistent with lower funds rates than the evidence suggested. Specifically, he would favor a range of 11-1/2 to 12-1/2 per cent for the funds rate.

Mr. Mitchell said he could accept the specifications shown under alternative B or some modification of them. He endorsed the view that a directive like that issued at the previous meeting, which focused on money market conditions, was singularly appropriate to the circumstances now prevailing.

The problems he foresaw, Mr. Mitchell continued, related to two contingencies. One was the possibility that market forces would lead to downward pressures on interest rates. The Committee had agreed in the inter-meeting period that a resurgence of expectations of declining interest rates should be prevented, and perhaps it could be assumed that it still held to that view. However, the chances that the market would ease against Committee policy, perhaps as a result of inflows of oil money, seemed greater now than in recent weeks. He thought it should be made clear that such easing--as a result either of a fall in demands for funds or an increase in supplies of funds from abroad--would not be permitted, at least in the period immediately ahead.

Mr. Mitchell observed that the other problem was more conjectural and the chances that it would arise were smaller. He had in mind the possibility that growth in the aggregates, which tended to be erratic, might slow more than expected. He thought a slowing in either M_1 or the bank credit proxy, no matter how large, should be accepted. However, if M_2 and M_3 slacked as a result

of further weakness in time and savings deposits, the Committee should be prepared to review the situation because of the risks of massive disintermediation.

Mr. Morris expressed the view that under present circumstances it should be the Committee's policy to apply as much financial restraint as possible without producing a generalized financial crisis. It seemed to him that if the Committee was not already close to the brink it was in that neighborhood; he thought the economy's ability to adapt to much more monetary restraint was rather limited.

Mr. Morris remarked that in view of the many unique circumstances of the current period, it was not possible to get much guidance from the past with regard to the optimum rate of growth in M_1. Mr. Clay was correct in saying that the Committee had been revising its targets upward; in his (Mr. Morris') opinion, it was necessary in the present new world to set targets pragmatically, because guideposts established in the past were not of much help. He was not sure he could accept Mr. Partee's view that the 7 per cent growth rate in M_1 so far this year was regrettable, if Mr. Partee meant by that statement that he would have been willing to accept the other conditions necessary to have held the growth rate down to 6 per cent. He felt intuitively, after talking with

financial market observers in the Boston area, that Mr. Debs was right in suggesting that there were many points of vulnerability underneath the present relatively quiet surface in the markets. If, for example, the Committee maintained its present posture for another 3 months, he would expect the emergency lending procedures to be activated for savings banks in the Boston area.

Mr. Morris said he thought the Committee's policy was working. Anyone who judged policy solely in terms of the rate of growth in M_1 might have doubts on that score, since there never had been a period of monetary restraint comparable to the present period in which M_1 was growing at a 7 per cent rate. That was a historic phenomenon. He agreed with Mr. Holland that M_1 might be a misleading indicator of the degree of restraint at the present juncture.

In concluding, Mr. Morris said he favored alternative B, with the modifications the Chairman had suggested.

Chairman Burns remarked that the members appeared to be unanimous in the view that the current basically restrictive monetary policy had to be maintained at least for the period immediately ahead. Before turning to the directive, it might be desirable to test the Committee's thinking with regard to specifications. He asked the members to indicate whether they found his earlier suggestions for aggregate growth rates to be generally acceptable.

A majority of the members responded affirmatively, for both the 6-month target rates and the 2-month operating ranges.

The Chairman noted that preferences expressed during the preceding discussion had been somewhat more diverse for the Federal funds rate range than for aggregate growth rates. He suggested that the members be polled with respect to, first, the choice between 11 and 11-1/4 per cent for the lower limit of that range, and secondly, the choice between 12 and 12-1/4 per cent for the upper limit.

The polls indicated that a majority favored 11-1/4 per cent for the lower limit and 12-1/4 per cent for the upper limit.

Chairman Burns asked whether it would be agreeable to the Committee to adopt a range of 11-1/4 to 12-1/4 per cent for the funds rate on the understanding that, if the Manager believed it was necessary or desirable to aim for a weekly average rate above 12 per cent, he would consult with the Chairman before proceeding.

There was general agreement with that suggestion.

Turning to the operational paragraph of the directive, the Chairman noted that sentiment appeared to be divided between retaining the money market language of the previous directive or reverting to the customary language of the type shown in the staff's drafts, which focused on the monetary aggretates. He asked whether the Manager thought the choice had much operational significance.

Mr. Holmes expressed the view that the operational significance would amount at most to a slight shading. In his opinion, the same results could be obtained in the coming period under either type of directive.

Chairman Burns then asked whether any of the members felt strongly about the matter.

Mr. Mitchell remarked that, in his view, an instruction "to maintain about the prevailing restrictive money market conditions" would be an accurate description of the Committee's objectives for the coming 4 weeks. Accordingly, he had a fairly strong preference for retaining the money market directive.

The Chairman commented that he agreed with Mr. Mitchell's observation about Committee objectives. Nevertheless, he had a slight preference for reverting to the customary formulation, which had served the Committee well for an extended period. He was concerned about the possibility that the Committee might find itself using money market directives on a regular basis.

Mr. Brimmer said he also felt that the choice had little significance for operations. It might, however, matter in terms of the degree of public understanding of the policy decision. On that basis, he saw some merit in using a money market directive for this period.

Mr. Wallich expressed a preference for the customary type of directive, formulated in terms of the monetary aggregates. Use of a money market directive might result in unwarranted criticism from those who had been critical of such directives in the past.

Mr. Mayo noted that the proposed "money market" directive included a clause reading "provided that the monetary aggregates appear to be growing at rates within the specified ranges of tolerance." He thought the inclusion of that clause would meet the objection Mr. Wallich had raised.

After some further discussion, it was agreed that the operational paragraph used in the previous directive should be retained.

Chairman Burns then suggested that the Committee vote on a directive consisting of the general paragraphs as drafted by the staff and the operational paragraph just agreed upon. It would be understood that that directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, the annual rates of growth for the third and fourth quarters combined--would be 5-1/4, 6, and 9-1/4 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the June-July period would be 10 to 13-1/2 per cent for RPD's, 3-1/2 to 7-1/2 per cent for M_1, and 5-1/2 to 8-1/2 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be

11-1/4 to 12-1/4 per cent, on the understanding that if the Manager believed it was necessary to aim for a weekly average funds rate above 12 per cent, he would consult with the Chairman before proceeding.

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

The information reviewed at this meeting suggests that real output of goods and services will be about the same in the current quarter as a whole as in the first quarter, but that there has been some improvement as the spring has progressed. The overall rate of price rise, while very large, is not quite so rapid as in the first quarter. In May industrial production increased somewhat for the second consecutive month, and nonfarm employment expanded substantially further. The unemployment rate moved above 5 per cent, however, as the civilian labor force rose sharply. Wholesale prices of farm and food products declined substantially further, but increases among industrial commodities again were widespread and extraordinarily large. The advance in wage rates accelerated somewhat further.

In May the depreciation of the dollar against leading foreign currencies was arrested. U.S. international transactions were in approximate balance on the official settlements basis, as bank-reported net outflows of capital apparently abated. The foreign trade deficit narrowed in April, despite a further large rise in the cost of petroleum imports.

Growth in the narrowly defined money stock moderated in May, but apparently it accelerated in early June. Net inflows of consumer-type time deposits at banks slowed in May, and deposit experience at nonbank thrift institutions continued poor. Business credit demands remained large, although the expansion in short-term credit was below the extraordinary pace of April and was less concentrated at banks. In May banks increased their outstanding large-denomination CD's substantially further and continued to borrow in the Euro-dollar market; most recently, however, they have reduced their reliance on these sources of funds. Market interest rates have fluctuated in a narrow range in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain about the prevailing restrictive money market conditions, provided that the monetary aggregates appear to be growing at rates within the specified ranges of tolerance.

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

Mr. Broida noted that at times in the past members dissenting from a directive had submitted explanatory statements after the meeting for inclusion in the record. The Committee might want to consider an alternative procedure under which dissenting members--in today's case, Mr. Clay--offered the reasons for their dissenting votes before the meeting adjourned.

In the course of the ensuing discussion Mr. Brimmer said he thought there would be advantages in having at least a summary of the reasons for dissenting votes at the time of the meeting. It would be useful, however, to hear from the Committee's General Counsel regarding any legal considerations that might bear on the matter.

Mr. O'Connell observed that the Federal Reserve Act required that the record of open market policy actions include the votes taken in connection with the determination of open market policies and the reasons underlying each such action. Statements of reasons for dissent were not required; however, there was nothing in the Act to preclude the presentation of such statements at the meeting or in subsequent submissions.

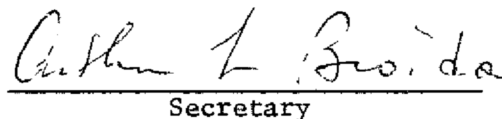
Chairman Burns expressed the view that it would be preferable to have reasons for dissents stated at the meeting--at least in general terms, with the precise language to be worked out later. It might be best, however, for the Committee not to adopt a rule on the matter but to leave the decision to the individual members concerned.

Mr. Clay said he would be happy to indicate his reasons for dissenting. He thought the Committee had accepted for too long rates of growth in the monetary aggregates that would result in a continuing and growing inflation. He believed that the

aggregates had not yet been brought under control, and that the longer that situation persisted the more difficult it would be to achieve control and the greater would be the damage done to the economy by inflation.

It was agreed that the next meeting of the Committee would be held on July 16, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

Resumè of Governors' Discussion at Annual
Meeting of the Bank for International Settlements
June 9, 1974

The meeting consisted of a tour d'horizon of economic developments in the member States. The preoccupation remained that of severe inflation in most countries. Some signs of economic slowdown were appearing, however, as policies focused on curbing inflation and tempering balance of payments deterioration.

In the United Kingdom, as in the United States, auto sales and housing production were weak, and some property companies were in a severe financial bind. With persisting shortages in some commodities, prices were still risng sharply, and cost of living escalators had been triggered for about a third of the labor force. Although the trade balance is in massive deficit, trade excluding oil seems to be improving.

In Germany, consumer prices are expected to be up about 7 per cent year-over-year. The trade balance remains strong but seems to be weakening somewhat. Interest rates are declining a bit as the central bank increased its purchases of dollars in the exchange market.

In France, the new government would be announcing its economic program in the coming week. With inflation progressing at a 13 per cent rate, fiscal policy was expected to be pretty tight. The trade balance, excluding oil, was not in bad shape.

In Switzerland, the central bank had had to step in to rescue a federal bond issue because the capital market had become so demoralized in the face of rapidly rising long-term interest rates. As a result, the authorities had been forced to close their market to foreign issues for the time being.

In Japan, industrial production is slowing, as is growth in the money supply. After a huge advance, the wholesale price index seems to be leveling off. Nevertheless, the authorities are persisting in an anti-inflationary policy, and they believe a recession is unlikely.

In Italy, the economic and political situation is serious. Domestic demand must be cut by 4-5 per cent to restore payments equilibrium, though the impact on domestic production need not be so sharp if increased exports take up 2 per cent of the slack. Politicians and labor unions now seem to be aware of the critical nature of the problems, and a recession is probably inevitable. (The Italian Government fell the day following the meeting.)

There was a brief discussion of the vulnerability of banking institutions to the strains of oil money flows. A full discussion of this issue is scheduled for the July meeting.

ATTACHMENT B

June 17, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on June 18, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services will be about the same in the current quarter as a whole as in the first quarter, but that there has been some improvement as the spring has progressed. The overall rate of price rise, while very large, is not quite so rapid as in the first quarter. In May industrial production increased somewhat for the second consecutive month, and nonfarm employment expanded substantially further. The unemployment rate moved above 5 per cent, however, as the civilian labor force rose sharply. Wholesale prices of farm and food products declined substantially further, but increases among industrial commodities again were widespread and extraordinarily large. The advance in wage rates accelerated somewhat further.

In May the depreciation of the dollar against leading foreign currencies was arrested. U.S. international transactions were in approximate balance on the official settlements basis, as bank-reported net outflows of capital apparently abated. The foreign trade deficit narrowed in April, despite a further large rise in the cost of petroleum imports.

Growth in the narrowly defined money stock moderated in May, but apparently it accelerated in early June. Net inflows of consumer-type time deposits at banks slowed in May, and deposit experience at nonbank thrift institutions continued poor. Business credit demands remained large, although the expansion in short-term credit was below the extraordinary pace of April and was less concentrated at banks. In May banks increased their outstanding large-denomination CD's substantially further and continued to borrow in the Euro-dollar market; most recently, however, they have reduced their reliance on these sources of funds. Market interest rates have fluctuated in a narrow range in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

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

Alternative B

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

Alternative C

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

ATTACHMENT C

June 18, 1974

Points for FOMC guidance to Manager in Implementation of directive		Specifications (As agreed, 6/18/74)
A. Longer-run targets (SAAR): (third and fourth quarters combined)	M_1	5-1/4%
	M_2	6%
	Proxy	9-1/4%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (June-July average):		10 to 13-1/2%
2. Ranges of tolerance for monetary aggregates (June-July average):	M_1	3-1/2 to 7-1/2%
	M_2	5-1/2 to 8-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		11-1/4 to 12-1/4%
4. Federal funds rate to be moved in an orderly way within range of toleration.		

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

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions. Also, it was understood that if the Manager concluded that it was necessary or desirable to aim for a weekly average funds rate above 12 per cent, he would consult with the Chairman before proceeding.