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, August 20, 1974, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman[1/]
Mr. Hayes, Vice Chairman
Mr. Black
Mr. Bucher
Mr. Clay
Mr. Holland
Mr. Kimbrel
Mr. Mitchell
Mr. Sheehan
Mr. Wallich
Mr. Winn

Messrs. MacLaury 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. Coombs, Special Manager, System Open Market Account
Mr. Sternlight, Deputy Manager, System Open Market Account

1/ Entered meeting at point indicated.

Mr. Coyne, Assistant to the Board of Governors
Mr. Wonnacott, Associate Director, Division of International Finance, Board of Governors
Messrs. Keir and Wernick, Advisers, Division of Research and Statistics, Board of Governors
Mr. Wendel, Assistant Adviser, 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

Messrs. Baughman, Leonard, and Plant, First Vice Presidents, Federal Reserve Banks of Chicago, St. Louis, and Dallas, respectively
Messrs. Eisenmenger, Scheld, and Sims, Senior Vice Presidents, Federal Reserve Banks of Boston, Chicago, 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
Messrs. Kaminow and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Mr. Ozog, Manager, Acceptances and Securities, Federal Reserve Bank of New York

The Secretary noted that Chairman Burns had been unavoidably detained, and that until his arrival Vice Chairman Hayes would serve as Acting Chairman.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on July 16, 1974, were approved.

The memoranda of discussion for the telephone conference meeting of the Federal Open Market Committee held on July 5, 1974, and for the meeting of the Committee held on July 16, 1974, were accepted.

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 July 16 through August 14, 1974, and a supplemental report covering the period August 15 through 19, 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:

> Both the exchange market and the Euro-dollar market are now looking a bit healthier as the shock waves from Herstatt have receded. Trading volume has continued to recover, but most of the speculative steam has gone out of the market; we no longer have outfits like Herstatt and the Sindona banks in Milan throwing tens of millions of dollars at us at the first sign of trouble. On the other hand, medium- and smaller-sized banks in Europe are still encountering trading difficulties, and market psychology remains apprehensive of new strains on the fragile world financial system. In effect, the market is looking for trouble, although no one is able to specify where and when it is likely to occur.

In operations during the period, we supported the dollar on three separate occasions. The first of these was to check selling pressure on the dollar immediately following the Supreme Court decision on the tapes. On this occasion we operated in a highly visible way and fairly forcefully, spending a total of $46 million worth of marks and Dutch guilders. This not only served to check the immediate threat, but was apparently interpreted by the market as a signal that we would resist new pressures arising out of other disturbing political events during this transition period. On August 8, we sold another $21 million worth of marks out of balances, as the dollar slipped following the announcement of the July wholesale price index. Also on that day, as you know, there were firm expectations that the President would resign that evening. On the following day, the dollar initially weakened still further after the President's resignation speech. We re-entered the market with simultaneous offers of three different currencies--marks, guilders, and Belgian francs--and this seemed to have a useful stabilizing effect.

Meanwhile, we were favored during the month by an encouraging improvement in both U.S. and German trade figures, by widespread reports of heavy flows of oil money into this country, by the easing of German credit policy, and finally by the resolution of the political crisis here. As the dollar strengthened from time to time in response to these influences, we not only paid off the new debt we had acquired in Belgian francs and Dutch guilders, but also made heavy repayments against our German mark debt, which is now reduced to $55 million from the peak of $382 million reached early in June. Meanwhile, we have been able to avoid any losses in paying off such debt, even though the circumstances were far less favorable than they were during our initial intervention during the summer months of 1973. Since we resumed exchange operations on July 10 of last year, we have accumulated over-all trading profits of $14 million, of which $4.9 million has accrued to the German Federal Bank under our profit- and loss-sharing agreement.

Looking ahead, if the dollar continues to firm I think we would do well to build up moderate holdings of foreign currency balances--primarily marks, but perhaps modest amounts of guilders and Belgian francs as well--so as to strengthen our capacity to deal with future setbacks to the dollar. Meanwhile, however, a further strengthening of the dollar may reflect increasing strains on some of our partner central banks in the swap network. Over coming months, I would not be surprised to see a number of inquiries as to the availability of Federal Reserve credit under the swap network.

As a matter of fact, 5 minutes after I finished dictating that last sentence, we had a formal request from the Bank of Mexico to draw the entire $180 million available under their swap line with us. Several days earlier, the Mexicans had raised this issue, and there had been discussions involving the Chairman, Governor Wallich, Mr. Bryant, and the Treasury. The request by the Mexicans had an unusual feature, since they were not seeking to spend the proceeds of that drawing of $180 million to meet continuing balance of payments drains. They had been running a deficit and had been drawing down balances in the street in New York, where they keep most of their reserves. They wanted to use the proceeds of the drawing to rebuild their balances. On those balances in the street, they were receiving the CD rate, which is appreciably higher than the Treasury bill rate charged on the drawing. Consequently, the possibility arose that this could be construed as a money-making operation, although I am sure that was not the case. The main thing was to replenish reserves that had been lost during the summer months.

We have worked out the following arrangement with the Mexicans, which in effect eliminates any possibility of their profiting on the drawing. We will continue to charge them the Treasury bill rate on their drawing, but when they repay in part or in full, we will adjust the forward rate on the swap in such a way as to absorb the interest rate differential between what we are charging them and what they earn on their placements in the street. Thus,

> they will make no profit on the drawing, and indirectly we will be getting a higher yield on the swap credit that we extend to them. At the Chairman's request we have also confirmed their understanding of the importance of keeping the credit short-term.
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> The Mexicans feel that their balance of payments situation has gone through a tough patch but will be improving shortly. They, like everyone else, were hit by the oil crisis, but they have taken steps--including the reopening of oil wells--to become self-sufficient in oil. I do not know whether their confidence is misplaced or not, but they do seem reasonably sure that they will be able to pull out of these difficulties. They have had a good record over the years; this is the first time they have drawn on the swap line and my own judgment is that this credit is well worth extending, especially under the safeguards we have introduced.

Mr. Wallich observed that the official settlements concept of the balance of payments had become ambiguous because placements in New York of funds accruing to oil-producing countries actually strengthened the U.S. position, although they were recorded as an official settlements deficit. He asked what might be done to prevent official settlements deficits from throwing off misleading signals.

Mr. Coombs remarked that he would scrap or downplay the concept, that it had become anachronistic and misleading because funds of the oil-producing countries could be shifted back and forth between placements in the United States, which were recorded as U.S. liabilities to foreign official agencies, and placements in the Euro-dollar market, which were not so recorded. More fundamentally, increases in the U.S. official settlements deficit in the present circumstances might be desirable--and as Mr. Wallich had observed, might indicate a strengthening rather than a weakening in the U.S. international payments position--if they reflected a willingness of the oil-producing countries to place funds in the United States.

Mr. Hayes asked whether there was any other single measure that was a better or more reliable indicator of the U.S. payments position.

Mr. Coombs responded that the market was likely to focus more and more on the trade balance and the current account balance, which together were useful indicators of underlying trends in the country's payments position.

Mr. Holland inquired whether it would be possible to develop some kind of balance on the official settlements basis adjusted to exclude changes in foreign official holdings of dollar assets that were investment motivated and that, consequently, had implications different from those traditionally associated with official settlements deficits.

In reply, Mr. Coombs said an effort could be made to develop such a measure, but he doubted that it would be successful. The volume of funds which might be shifted back and forth between the Euro-dollar market and the United States had become so large that shifts in those funds in response to interest rate differentials could swamp changes in dollar holdings of foreign monetary authorities resulting from their exchange market intervention. The Arab oil-producing countries probably had placed as much as $8 billion in the Euro-dollar market. If the United States succeeded in getting the Arab countries to shift the funds into U.S. Government securities, the official settlements deficit would be enlarged by the shift.

Mr. Wallich commented that one possibility would be to eliminate U.S. liabilities to the OPEC countries from the calculation of the official settlements balance.

Mr. Morris remarked that it would be desirable to develop another line in the balance of payments accounts, showing the official settlements balance exclusive of the holdings of the OPEC countries, in order to give the public more information on developments.

In response to a question by Mr. Kimbrel, Mr. Bryant said more detailed information was being obtained concerning liabilities of U.S. banks and other U.S. institutions to OPEC countries, and staff analysis would take account of changes in those liabilities. In his opinion, however, the importance of the problem concerning the official settlements balance could be exaggerated; that balance never could reveal all that one would want to know about the U.S.

payments position. Now, it was likely to fall into disuse, just as the liquidity balances had, and appropriately so.

Continuing, Mr. Bryant observed that the balance of payments statistics were merely double-entry bookkeeping accounts. No single line drawn through these accounts, no matter where drawn, could possibly yield a measure that would summarize everything one needed or would like to know about the over-all payments position. In the present circumstances, with exchange rates more endogenously determined in the international system, it was even more difficult to evaluate the payments position than it had been under a system of fixed rates. The dimensions of exchange rates differed from those of the balance of payments accounts. In its own analysis, the staff considered changes in both rates and the accounts, but so far it had not been able to devise a simple way of combining the two into a single statistic that would indicate what one needed to know about the over-all situation.

Mr. Holland asked whether the unhappiness and discomfort that had developed in international banking circles as a result of the protective payments procedures adopted by U.S. banks after the Herstatt failure were now past or whether there were continuing difficulties that the System ought to be concerned about.

Mr. Coombs replied that there was continuing irritation because of the recall provision. Although the number of recalls had been minimal, the provision had created uncertainty about whether recalls would occur and whom they might affect. Within the New York banking community, there was a difference of opinion concerning the need for the provision; one large bank was insisting on retaining it, but a number of other banks thought it would be safe to drop it. Recently, he had asked a representative of the large bank whether it would be willing to operate without the provision for a week's trial period, and such a development was likely to occur in time. At present, the provision was more of an irritant than a substantive factor in the foreign exchange markets. The volume of transactions in the markets was recovering quite well.

Continuing, Mr. Coombs remarked that a more fundamental problem was the shift that had occurred in the attitudes of the major banks in New York and abroad with respect to their lines to other banks. The lines were being reviewed, and a representative of one large New York bank had indicated that his bank might prune as many as 200 from its list of 600 banks. That would be a blow to many small- and medium-size banks in Europe, which in most cases were well run but nevertheless were being caught in the fallout from the Herstatt failure.

In response to a question by Mr. Mitchell, Mr. Coombs remarked that the losses arising from the Herstatt failure had not been recovered. Officials of the German Federal Bank had indicated that they had no legal power to rectify the situation and that the problem was in the hands of the courts.

Mr. Eastburn asked whether the European central banks meeting in Basle were likely to approve a monitoring of developments in the Euro-dollar market in view of the present dangers there.

Mr. Coombs replied that the Bank of England closely monitored the matching of maturities of U.K. banks that operated in the Euro-dollar market, and he believed that the Dutch, Belgian, and Italian authorities also did. The German authorities probably did not do so to the same extent, because a number of German banks conducted Euro-dollar operations through their Luxembourg branches and good data on those operations were not available to the authorities. In his view, the Euro-dollar market was the weak link in the chain; if difficulties developed, they were likely to begin in that market. Many small- and medium-size banks were locked into 5- to 7-year loan commitments, and they were having to refinance at rates that cost them money. On the 6-month renewal arrangement on such medium-term loans, the lending rate was the London-offered bank rate, which was below the rate the banks were having to pay for funds.

By unanimous vote, the System open market transactions in foreign currencies during the period July 16 through August 14, 1974, were approved, ratified, and confirmed.

Mr. Coombs then noted that $55.2 million of a drawing made last spring on the swap line with the German Federal Bank would mature for the second time on August 30. He was hopeful that it would be possible to pay off the debt by then, but he was inclined to wait a little longer, if necessary, in order to get a slightly more favorable rate and avoid a loss. Therefore, he would recommend renewal of the remainder of the drawing, in the event that it was not paid off by August 30. Renewal was agreeable to the German Federal Bank.

Mr. Wallich commented that he had no objection to the renewal. However, considering that the System had been insistent on viewing swap drawings--including the recent Mexican drawing--as strictly short-term, it ought to apply that attitude to its own drawings and, as a general rule, pay them off earlier rather than later.

Mr. Holland observed that he would not object to the renewal either, but he would like to tilt the preference curve just a little in the direction of earlier repayment. At a time when the System itself had a record of long-outstanding debts on a few of its swap lines, he would be willing to lose some of the System's $9 million of profits on foreign exchange operations for the sake of cleaning up the most active of the swap lines.

In response, Mr. Coombs observed that in the case of the Mexican drawing the System might have been a little severe. One renewal of a swap drawing generally had been regarded as routine, and in fact the Committee did not require approval of a renewal until a drawing had been outstanding for a year. In his view, it would be a mistake to attempt to limit System drawings to no more than 3 months. With respect to the preference curve, he thought his was probably the same as Mr. Holland's. One difficulty, however, was that the German Federal Bank would share in any loss incurred in paying off the drawing in question. He personally would feel embarrassed to incur a loss in which that Bank would share, if the dollar was strengthening and delay of another week or so would permit paying off the debt without any loss and perhaps with a profit.

Mr. Mitchell asked about the status of the outstanding drawings on the Belgian and Swiss swap lines.

Mr. Coombs replied that informal negotiations were being conducted with the Swiss authorities concerning a sharing of losses on a 50-50 basis. At present, the rate on the Swiss franc was roughly 3.00 to the dollar. If the rate moved to 3.37, no losses would be involved in repayment of the debt. In informal discussions with the Swiss, he had obtained fairly firm indications that they would be prepared to incur losses involved at a rate of 3.15 or better. The rate could reach that level during the next few weeks.

With respect to the Belgian debt, Mr. Coombs said a memorandum had been sent to the Subcommittee recommending that the System accept the willingness of the Belgian Minister for Finance to honor the revaluation guarantee with respect to the 2-3/4 per cent revaluation of the franc; that the outstanding debt be written up to reflect not only that revaluation but also the two devaluations of the dollar; and that the Belgians be urged to share losses with the System on a 50-50 basis whenever losses were incurred because of a rise in the franc above its central rate. His guess was that the Belgians would not be willing to share losses on the basis of that final recommendation, which would further delay repayment of the debt.

Mr. Holland, noting that the Committee had de
the Subcommittee the authority to resolve the problem
the terms of repayment of outstanding debts in Belgiar
remarked that he hoped the issue would be settled pror

> Renewal for a further period of 3 months of a System drawing on the German Federal Bank, maturing on August 30, 1974, was noted without objection.

Vice Chairman Hayes then called for the staff
the domestic economic and financial situation, supplem
written reports that had been distributed prior to the
Copies of the written reports have been placed in the
the Committee.

Mr. Gramley made the following statement regar(
staff's view of the economic outlook:

> Incoming evidence over the past month has rec
> further the prospects for an early recovery of ecc
> activity. Industrial production remained unchange
> July for the second month in a row, and with revis
> of back data, there has been only one month this y
> May--in which industrial output has registered a s
> icant increase. Housing starts were off sharply f
> in July, and permits also fell to just over 1 mill
> units, annual rate. And there are likely to be fu
> declines in housing activity in the months ahead,
> what is happening to savings inflows to thrift ins
> tions. Judging by partial data, August flows to s
> and loan associations and to mutual savings banks l
> shrunk further from the already weak 2 per cent an
> growth rate recorded in July.

Recent retail sales figures have been more heartening. There apparently was a good increase in real retail purchases in July, judging from the advance report, and auto sales have rebounded vigorously in the last two 10-day sales periods. But there is little basis as yet for assuming that consumer buying is coming out of the doldrums. In particular, we may well find that current higher rates of new car sales are borrowing from the future, because consumers know there will be huge price increases on the 1975 models.

In assessing the economic outlook, our staff thinking has been influenced most by developments affecting the prospects for business investment in inventories and in fixed capital.

The new figures coming out of the July GNP revision imply a much different relation than before between inventories and final sales. Inventories in real terms were revised up substantially; real final sales were revised down. The aggregate ratio of inventories to GNP final sales--in 1958 dollars--is now about as high as it was in the last three recessions.

Are these new inventory figures to be taken at face value? Probably not. They are obtained, in part, by carrying forward from the end of 1972 an upward bias adjustment in reported stocks of manufacturing and trade firms. On the other hand, they seem more consistent than the old figures did with other economic and financial data--that is, with huge business short-term credit demands this year, with the improvement in inventory condition reported by manufacturers since mid-1973, and with reports in the red book[1/] and elsewhere of shortening delivery times, an easing of shortages, and more cautious inventory buying. Prospects for a decline in the rate of inventory accumulation--especially in materials--must now be regarded as quite high.

For business fixed capital investment, too, some cracks have begun to appear in what we once regarded as a wall of strength for the future. For machinery and equipment, the near-term outlook is still reasonably good. New orders for nondefense capital goods in real terms have flattened out, but they have not yet declined

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

significantly, and unfilled orders are very large and still rising. But for structures, the outlook is poor. Contract awards are off substantially from last fall, and there is little basis for expecting a near-term recovery. Commercial construction, we are told, is in trouble in many sections of the country. Public utilities, furthermore, have made substantial cuts in their capital spending plans. Since April, announced cancellations of cutbacks by utilities affecting capital spending over the next half decade or so aggregate around $8 billion; of this, at least $700 million involves expenditures in 1974. So far, cutbacks outside the utilities are small, but the current red book, as well as other reports we have heard, suggest they are spreading.

Once business fixed capital is added to the list of sectors showing actual or prospective weakness, the chances of avoiding a recession become rather bleak.

The reasons why the pace of aggregate demand has slowed so much over the past year or so are many and varied--as is always the case. A few words may be appropriate as to the role that monetary policy has played.

In nominal terms, growth of the monetary aggregates over the past year and a half--though slowing--has still been relatively high by historical standards. But in evaluating the posture of monetary policy, one must come to grips with what inflation has meant for real supplies of money and credit. Growth in the real money stock--that is, nominal M_1 deflated by the CPI--turned negative in early 1973, and it is still declining markedly. Accompanying this decline have been the familiar signs of monetary restraint--sharply rising interest rates; a sick stock market; disintermediation and weakness in housing activity; congestion in capital markets; postponements or cancellations of security offerings and capital expenditures; increasing reports of difficulties experienced by small businesses and others in securing credit; and a slowdown in collection of receivables. I conclude, therefore, that monetary restraint has been biting, and that it has been--and continues to be--an important factor in dampening aggregate demand.

Mr. Bryant made the following statement regarding the implications of foreign economic developments for domestic prospects:

Recent economic developments in the rest of the world show marked similarities with developments here in the United States. One obvious similarity is that prices have continued to rise at extraordinarily rapid rates in all industrial countries. While U.S. price performance has been unsatisfactory, it has been less adverse than Japan's and marginally less unfavorable than a weighted average for OECD Europe.

Damping inflation has been the main priority of policymakers in other countries, as in the United States, and many policy actions intended to restrict aggregate demand were taken during the last 2 years. Partly because of these policy actions, we have recently witnessed a sharp deceleration of economic activity in Japan and Europe. This, too, is similar to U.S. experience. Indeed, by the first half of 1974 industrial output in OECD Europe and Japan was significantly below the levels attained late in 1973. To be sure, output this year in many countries was distorted by the effects of the oil embargo. But data for recent months, in which supply-induced constraints on output were much less important, continue to show a general pattern of sluggishness.

What about the outlook? The most recent projections that purport to be comprehensive are those made at the OECD in June and published in July. These projections showed a gradual slowing in the pace of inflation in all the major countries. Nonetheless, consumer prices would still be rising in the first half of 1975 at historically very high rates: for example, 15 per cent in Japan, 9 per cent in Germany, and 7-1/2 per cent in the United States.

Real GNP in the seven major OECD countries combined was projected by the OECD to start growing again in the second half of 1974 at a 2-3/4 per cent annual rate, after falling in the first half of the year at an annual rate of nearly 2 per cent. Moreover, the recovery was projected to pick up further momentum in the first half of 1975.

Even in June, there were substantial risks that the pick-up in economic activity in the major countries would be weaker than projected by the OECD. By now, in mid-August, the probability of this OECD projection being over-optimistic has risen further, for three reasons.

First, government and private forecasters in several foreign countries--including Germany, Japan, Italy, and the United Kingdom--have been revising downwards their own projections of domestic demand. As an illustration, a senior official at the German Federal Bank is recently reported to have projected an annual rate of growth in German real GNP in the second half of this year of only 1-1/2 per cent, instead of the 3-1/2 per cent embodied in the OECD June projections.

Second, the Federal Reserve staff now foresees a much weaker U.S. economy than that incorporated in the OECD projections. By the first half of next year, the OECD projection has real growth recovering in this country at a 3 per cent annual rate; our staff projection is for a decline of 1-1/2 per cent.

A third reason why the OECD June outlook is suspect--and this is, of course, related to the two previous points--is that the projections for most of the countries individually relied importantly, and considerably more so than in past periods, on increases in net exports to boost total demand. Each country individually seemed to be counting on demand in the economies of its trading partners to be somewhat stronger than it foresaw for itself at home. The difficulty, of course, is that economists have not yet learned how to have one country make an export without some other country absorbing an import.

It is a sobering recollection that during 1972 and 1973, when all the industrial economies were expanding simultaneously, most national forecasters underestimated the boom in prices and activity in part because they paid too little attention to the cumulating and reinforcing international effects. Similar miscalculations could conceivably be made in the remaining months of 1974, but this time with opposite implications for production and employment.

All things considered, the recent OECD projections are probably in the right ballpark with respect to rates of price increase, but are almost surely wrong by a substantial margin with respect to economic activity. The over-all outlook for the world economy, in other words, is broadly similar to the outlook for the United States: only a gradual abatement of inflation and a period of continuing, marked weakness in production and employment.

Mr. Partee made the following concluding comments:

Taking into account the kinds of considerations that Mr. Gramley and Mr. Bryant have outlined, the staff has been constrained to reconsider the shape of its economic forecast for the period ahead. In so doing, we have also taken the opportunity to extend the projection period out until the end of 1975. What results is the picture of a very soft economy--one that shows negative real growth through much of the period. But we have not assumed a more expansive fiscal policy than before--with the exception of a larger public service employment program--since the thrust of the new Administration's thinking is strongly in the direction of greater economy in Government. Nor have we assumed a more expansive monetary policy in terms of the aggregates; M_1 is projected to rise at a 5-1/4 per cent annual rate in the second half of 1974 and at 5-3/4 per cent thereafter.

There are four main sources of the ad itional weakness expected in economic performance. Business inventory investment, though projected to level off at about the same rate as before, drops from a higher rate of accumulation in 1973 and the first half of 1974 than the figures had shown before; the result is greater interim weakness in current output over the next several quarters. Business plant and equipment outlays in real terms are now expected to drift downward beginning late this year, reflecting cutbacks and stretchouts, particularly by the utilities and in commercial construction. Housing starts are also expected to be significantly weaker than before, though we are projecting some upturn in the second half of next year as net savings inflows improve and the backlog of housing needs becomes more pressing. Finally, foreign demand for our nonagricultural exports in real terms seems very likely to be tilting downward, in sharp contrast to the large increases experienced since mid-1972.

What we have allowed for, you will note, constitutes only a small additional amount of weakness in each of these sectors, compared with the earlier forecasts. One could readily imagine a considerably larger shrinkage in any of these areas. Nevertheless, the cumulated effect is to keep the change in real GNP slightly negative and to create more softness in labor markets. We think that real GNP may be growing modestly again by the latter part of 1975, as housing turns upward and real consumer incomes benefit from larger gains in wages than in the price level. Though we expect very slow growth in the labor force and are assuming a substantially expanded public employment program, the unemployment rate is projected to be moving up throughout the next six quarters, to well over 7 per cent by the latter part of 1975.

Despite growing slack in the economy and substantial unemployment, our projection of the inflation rate has again been revised upward. The reasons for this are twofold. First, the drought in the mid-West is likely to put additional upward pressure on food prices, extending well into 1975 as the availability of meat supplies is gradually curtailed. Second, we are now projecting larger wage rate increases, in conjunction with the continuing rapid advance in consumer prices, while productivity gains are likely to continue well below the long-term trend. Thus, we believe that unit labor costs will be rising at an annual rate of close to 9 per cent over the next several quarters, before they begin to moderate. Consequently, the advance in prices, though diminishing, is expected to remain very high; not until the second half of 1975 does the rate of inflation fall below 7 per cent.

The continued rapid increase in prices will tend to produce sizable gains in nominal GNP, even if real GNP growth remains slightly negative as we have projected. Therefore, money growth along the projected

> path will remain below the rate of expansion in nominal GNP, though less so than in the past several years. Depending on one's estimate of the trend factor in the velocity of money, this implies a degree of continuing restraint in money and credit markets. If so, this could be the very rare case in which interest rates remain quite high throughout a mild but protracted business recession.
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> Looked at another way, real growth in the money stock--even with M_1 expanding at a 5-3/4 per cent rate--is likely to remain negative throughout 1975. The negative real growth would be less than it has been over recent quarters, so that the upward pressure on interest rates should diminish. There might well be periods in which rates tend downward--particularly in early 1975--but on balance we would expect that rates would persist at around their current levels. Given a policy of continued monetary restraint, measured in terms of the real money stock, we believe that the Committee must be prepared for an abnormally long interval of tightness and distortion in credit markets, and for the difficulties with the liquidity positions of many individual institutions and firms that this condition is likely to engender.

Mr. Bucher asked what the basis was for the staff assumption of an expanded public service employment program.

Mr. Partee replied that while no funds had been appropriated as yet, the possibility of an expanded program had received a good deal of public comment and it appeared to have a good chance of being approved. The staff had assumed a program that involved expenditures at an annual rate of about $4 billion by the second half of 1975 and that would employ an additional 375,000 persons by that time. Without such a program, the unemployment rate in the second half of 1975 would be about four-tenths of a percentage point higher than projected.

Mr. Leonard commented that for the past several months the staff at the St. Louis Bank had seen more strength in aggregate demand than suggested by the projections in the green book,[1/] and the St. Louis staff had expected a small increase in real GNP in the second quarter instead of the small decline indicated by the preliminary figures of the Commerce Department. Representatives of firms in the Eighth District continued to speak more of strength than of weakness, and the Bank's staff continued to see more strength than did the Board's staff. That view was based in part on skepticism that the price indexes used to deflate nominal GNP were reliable in a period of price controls and just after the removal of such controls. Controls often served to limit increases in price indexes more than increases in actual prices, and when they were removed, the indexes tended to catch up with actual prices. In the recent period, moreover, quantity weights--especially for something like gasoline--might have become inappropriate because of the large shifts in relative prices.

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

Mr. Leonard observed that from the second quarter of 1972 through the second quarter of 1973, the reported annual rates of growth in real GNP were very high; quarter by quarter, they were 8.4, 6.0, 8.3, and 9.5 per cent. Such rapid rates of growth did not appear to be supported by the behavior of employment, and it was likely that the rise in prices was understated and thus the expansion in real output was overstated in that period. It might also be significant that the St. Louis Bank's model had projected for the Phase II period a more rapid rate of increase in the GNP deflator than was officially reported. In the first two quarters of this year, on the other hand, the rate of increase in prices might have been overstated and real output correspondingly understated. And for that period, the St. Louis model had projected lower rates of increase in prices than had been reported.

Continuing, Mr. Leonard remarked that in search of additional support for the notion that since mid-1972 real GNP growth had first been overstated and then understated, the Bank's staff had calculated the change over every two-quarter period from the beginning of 1947 to date. Against the background of those calculations, the 4.1 per cent annual rate of decline reported over the first two quarters of 1974 appeared unusually large. That period had a percentile rank of 2.8, meaning that in only 2.8 per cent of the other two-quarter periods was there as large a decline in reported real GNP. Moreover the relatively poor performance of real GNP in the most recent two-quarter period was not borne out by the behavior of industrial production, total employment, or payroll employment, which had percentile rankings of 18.5 per cent, 29.8 per cent, and 33.3 per cent, respectively.

In conclusion, Mr. Leonard said monetary policy had been restrictive for only a short time, and it was still the view at the St. Louis Bank that aggregate demand was stronger than suggested by the Board staff's projections.

Mr. Partee observed that the Board's staff also had examined the historical relationships between real GNP and industrial production and employment. It had found that in the first two quarters of this year, the relationships fell toward the low end of, but not outside, the range of experience, and therefore, they did not provide firm support for a conclusion that real GNP was understated. Some question about the real output figures might be raised by the extremely poor performance of productivity in the first two quarters of the year, reflecting developments in the services sector. It was possible that real GNP was a little stronger in that period than indicated by the official figures, but it was not certain, and any understatement probably was small.

With respect to the deflators, Mr. Partee said he doubted that the increases were seriously understated during the period of controls or overstated subsequently; a large number of the price indexes used to deflate nominal GNP were components of the consumer price index, and for the most part, they were based on prices collected in the stores rather than on quoted or nominal prices.

Mr. Eastburn said he was troubled by the use of the concept of the real money supply. While it could be useful in studying the past and in explaining financial market pressures, there were some dangers in using it as a policy target. Specifically, an effort to correct what might appear as an unduly low real money stock might simply reinforce the upward price spiral. Consequently, he believed that it might be better to judge the stance of policy by comparing current growth rates in the nominal money supply with rates in the recent past rather than with the rise in prices.

In response, Mr. Partee observed that it was conceptually possible to hold the growth of the real money stock close to zero and at the same time permit the nominal money supply to grow fast enough to finance a hyperinflation, and the concept of the real money stock had to be used with caution. At times, it might be desirable to have little or no growth in the real money stock, or even a decline. Nevertheless, the money stock had something in common with all measures that were in terms of current prices, and it had been found necessary to deflate, for example, retail sales and some of the leading indicator series in order to track developments. In the first half of the year the money supply grew at an annual rate of 6 per cent, but after allowance for a rise in prices at nearly twice that rate, monetary growth clearly was not rapid in relation to cash needs to maintain the volume of transactions in real terms.

Mr. Gramley added that over the past 20 years or more a protracted decline in the real money stock had always been followed by a recession. Indeed, the staff at the First National City Bank of New York--which was strongly monetarist--had produced evidence showing that real GNP was correlated much more closely with the real money stock than with the nominal money stock. In the current period, it was important that much of the increase in prices could be described as special factor inflation--that is, inflation resulting from exogeneous forces such as supplies of foods and decisions of foreign producers of oil. A decline in the real money supply resulting from that kind of inflation differed in its implications from a decline attributable to inflation generated by excessively rapid growth in the nominal money supply.

As Mr. Partee had suggested, it would be erroneous to conclude that monetary policy had been expansive over the past year because the money stock had grown 6 per cent.[1/]

Mr. Eastburn said it was his impression that a succession of several quarters of small declines in real GNP, as projected by the staff, was unusual. He wondered what the probabilities might be that the economy would follow such a course.

Mr. Partee replied that declines in real GNP during the postwar period typically had been small; the unusual feature of the projection, as Mr. Eastburn had suggested, was the number of quarters of small decline. He suspected that the projections could be questioned because weakness was dispersed over many sectors, and the over-all decline could well be larger than that projected. On the other hand, the Board's econometric model had yielded results broadly similar to the judgmental projections. Throughout the postwar period, moreover, the economy had demonstrated recuperative powers.

Mr. Gramley commented that the staff had not projected larger declines for two reasons. First, there was some reason to suspect that the recent upward revision in the inventory figures--based on a bias adjustment forward from the end of 1972--

1/ Chairman Burns entered the meeting during the course of Mr. Gramley's remarks.

resulted in an overstatement of the current level of stocks. Had the staff accepted the results of the model, it would have projected a decline in inventory investment to a negative rate rather than a leveling off at a fairly high positive rate. Secondly, the staff expected business fixed investment to be better sustained than in other periods of general weakness, because capacity in the major materials industries was still inadequate.

Mr. Winn remarked that he also had reservations about using the real money stock concept, that too much emphasis on it could lead to excessive increases in the nominal money stock and to a very rapid inflation. Looking ahead, he wondered whether the negative impact of high interest rates might moderate over the next year, if rates were stable rather than rising.

In response, Mr. Partee observed that a learning process did take place, and stability in interest rates--even at high levels--might tend to bring about some strengthening in demands. Such a notion was involved in the projection of an upturn in residential construction in the second half of next year. However, the projected decline in the rate of inflation was a partly offsetting influence. For example, incentives to accumulate inventories would lessen as the expected rate of inflation declined relative to interest rates. In any case, he would be concerned about the implications that a sustained high level of interest rates would have for the burden of debt and for the ability of consumers and of the public utilities and other businesses to meet their obligations.

Mr. Clay observed that he did not see much evidence of the reported large build-up in inventories and was skeptical of the recent upward revision in the inventory statistics. There were still shortages of most steel items, and there did not seem to be much variety available in types of lumber, automobiles, or clothing. Although there appeared to be some accumulation of stocks of appliances, there was little evidence of price reductions. He asked where the staff thought the reported inventory accumulation had actually occurred.

Mr. Partee said he was also impressed by the reports of shortages in lines where supply should be ample. However, it was difficult to determine whether such shortages were real or had resulted from attempts to accumulate stocks in anticipation of price increases. This year, supplies had been improving gradually. The reports in the red book indicated that petrochemicals and lumber were in better supply. In fact, lumber mills in the Pacific

Northwest were reported to be reducing output, and plywood prices had been softening. Various reports suggested that there had been improvement in nonferrous metals industries and that order books in the steel industry were less full than had been anticipated only a month or two earlier. Nevertheless, more spot shortages did seem to exist than might be expected after a period of slow growth in real GNP.

Mr. Gramley added that there seemed to be no doubt that automobile stocks were high; the industry had a 55-day supply of domestic models, which was well above year-ago levels. During the first half of the year, the rate of accumulation of inventories of miscellaneous materials was very high, suggesting that manufacturing and trade firms were building up stocks of materials which had recently been in short supply and whose prices were rising rapidly. That kind of accumulation appeared to be unsustainable.

Mr. Hayes remarked that one of the directors of the Federal Reserve Bank of New York had reported that the textile supply situation was distinctly easier than it had been and shortages apparently no longer existed.

Mr. Wallich remarked that Mr. Bryant's description of the evolving international situation might be interpreted as the beginning of a cumulative downward process, as various countries began to attempt to reduce their deficits by cutting imports. The strengthening of the dollar might be part of that effort, as countries attempted to accomplish their objectives by letting their exchange rates decline.

In response, Mr. Bryant said his purpose had been to call attention to the risks of miscalculation, but he did not think that many nations as yet were taking deliberate policy actions that might be described as competitive in the sense of being designed to reduce imports and to promote exports. He was concerned that everyone--as suggested by the country forecasts embodied in the OECD projections--was relying on a strengthening in exports at the same time that imports were expected to decline because of weaker domestic demand. Hence, he was concerned that the various forecasts might not be consistent with one another.

Mr. Wallich then observed that he viewed the staff projection with both alarm and skepticism. It was the most pessimistic of the projections he was aware of, but it was difficult to single out any particular part to raise questions about, because weakness was spread over the major sectors. It was surprising that interest rates were expected to remain high although the economy was projected to be weak. Also, one would expect net exports to improve and to impart some strength to the economy, but net exports were projected to deteriorate further. The real money supply had declined, and he did believe the concept was meaningful, but the central bank could not determine the real money stock; attempting to do so would be a serious mistake. At the same time, real interest rates were very low--in fact, they were negative--and he wondered why a negative Treasury bill rate did not have more of a stimulative effect.

In response, Mr. Partee commented that interest rates were expected to remain high even in recession basically as a result of the assumption that monetary policy would remain on a course that would prevent rates from declining. As had been pointed out, the nominal money stock was not growing as rapidly as nominal GNP, because of the high rate of increase in prices. Apart from the level of interest rates, there were structural problems affecting flows of funds to particular sectors. For example, many potential home buyers might now be willing to pay a mortgage rate of 10 per cent, but the funds simply were not available because of the poor deposit experience of the savings and loan associations and the mutual savings banks.

Mr. Holland observed that just as export demands had been underestimated in recent years, so had the upward price pressures associated with those demands, and a great deal had been learned about price discrimination between domestic and international markets and about the price elasticities of internationally traded commodities. Therefore, he wondered whether greater-than-expected weakness in export demands in the period ahead might also generate more downward pressure on some prices than was now projected.

In response, Mr. Bryant commented that prices of some commodities might be subjected to some downward pressure--or to less upward pressure--than anticipated if export demands fell short of expectations. However, there were also influences working in the other direction. The recent estimates of crop production in this country, for example, had led to a turnaround in prices of foodstuffs. It was possible that those opposing forces might about offset one another, so that the OECD projections of price increases seemed much less likely to be incorrect than did the projections of real economic activity.

Mr. Holland then remarked that he had gathered from the discussion concerning the real money stock that the staff was not asking the Committee to accept that variable as a target but was merely suggesting an additional way of examining an issue and helping the Committee to avoid overemphasizing the nominal money stock. With respect to the staff's projections, he was intrigued by the implicit projection of a significant rise in real interest rates in the remainder of 1974 and by the further rise in 1975, and he asked how that could be explained.

In response, Mr. Gramley commented that real interest rates were defined in terms of the relationship between current interest rates and the expected--not the current--rate of inflation. Businessmen surely did not expect the recent rate of inflation--which reflected a number of special factors--to persist into the indefinite future. The average businessman probably was projecting a rate of inflation in the 6 to 8 per cent range. There was no way to forecast the price expectations that businessmen would hold next year, so one could not judge the course of the real rate of interest.

In addition, Mr. Gramley remarked, one could not conclude that there was no interest rate constraint on demand because the

Treasury bill rate was negative in real terms; many borrowers were confronted with interest rates that were much higher. For example, some construction firms were paying rates of 15 to 18 per cent, and they were canceling building plans because they could not make a profit. Interest rate constraints were also beginning to affect utilities, and they would probably spread to the industrial sector.

Mr. MacLaury asked what the basis was for the projected turnaround in residential construction and improvement in consumer real income in the second half of 1975, which were the major factors in the upturn in real GNP in that period.

Mr. Partee replied that in the second half of 1975 larger increases in wages than in prices and a sizable cost of living adjustment in social security benefits--scheduled to take effect next July 1--would bolster expansion in purchasing power. With respect to residential construction, an upturn in the second half of next year did not seem unreasonable as the backlog of housing needs became more pressing and if, as projected, net savings flows into the nonbank thrift institutions improved. More generally, as he had observed earlier, the economy had demonstrated the potential to recuperate over a period of time. However, a great deal could happen in the intervening period of nearly a year that might substantially worsen or improve the course of economic activity.

Chairman Burns commented that there was little basis for projecting an upturn in the second half of 1975. However, he was skeptical of the projection that real GNP would decline for as many as six consecutive quarters.

Mr. MacLaury, noting that the staff's judgmental projections of real GNP for the period through the second quarter of 1975 had been revised downward repeatedly, asked whether the performance of the econometric model had been any better.

In response, Mr. Gramley observed that the model had suggested the current and prospective weakness in economic activity earlier than had the judgmental projections--a development which tended to increase the staff's confidence in the model. However, careful sector-by-sector analysis of the model's results was still necessary. For example, the model now projected stronger growth in real GNP late next year than did the judgmental projections, because residential construction was expected to stage a good recovery despite a projected rise in the Treasury bill rate to 12 per cent. Such a development was questionable. It occurred because the restraining influence of credit availability on residential construction did not persist for long in the model; real interest rates became the dominant influence, and they were low because of the projected rapid rise in house prices.

Mr. Sheehan asked how large the Federal deficit was expected to become and how the projected shortfall in real activity compared with experience in previous recessions.

Mr. Partee replied that, as usual in a recession, there was a substantial difference in behavior between the actual budget and the high-employment budget. The projections suggested that the actual budget deficit would rise to $18.5 billion in calendar year 1975 and level off at a rate of $22 billion in the second half of the year. On the high-employment basis, however, there would be a surplus of $16 billion in 1975. Compared with the recession of 1969-70, the shortfall in real output projected for 1975 was considerably larger; it was more like that in the recession of the late 1950's. For example, the rate of unemployment, without allowance for an expanded public service employment program, was projected to be around 7-3/4 per cent.

Mr. Kimbrel--noting the recent sales of new financing instruments that appealed to individual investors and the high proportion of noncompetitive bids in the recent Treasury financings--asked whether the average household had the financial resources to withstand the rise in prices, and perhaps some period of unemployment, without extreme difficulty.

Mr. Partee responded that over the projection period, the personal saving rate was relatively high, but it did not change significantly. In his opinion, savings for the most part were accumulated by people with higher incomes than those of the workers likely to become unemployed. The new financial instruments, in his view, had little if any impact on the saving rate. Rather, they brought about shifts of individuals' funds from financial-institutions into market instruments. Shifts of funds into Citibank's variable-rate note were clearly reflected in the very poor deposit experience of the nonbank thrift institutions in late July, and it appeared likely that this month's experience also would be very poor.

Mr. Hayes asked why housing starts were projected to decline further through the first half of 1975.

In reply, Mr. Partee commented that the current volume of housing starts depended upon the volume of new mortgage commitments made last spring and that starts in the first half of 1975 would depend upon the commitments made in the second half of this year. At present very few financing commitments were being made, with the result that starts would fall once the financing commitments made last spring were taken down.

Mr. Hayes then inquired whether consumer purchases of new automobiles might not prove to be higher in the current quarter than projected, given the incentive to buy in advance of the substantial price increases that would take effect when the 1975 models were introduced.

Mr. Partee said he agreed that the price increases for the new models might produce that result. In addition, General Motors was allowing its dealers to sell the new models as they began to be received this week rather than, as in the past, requiring them to hold the new models in inventory until the formal introduction dates late next month. In his judgment, however, any gain in sales in the current quarter attributable to those influences would be offset by a shortfall in the fourth quarter.

Mr. Gramley added that if new auto sales in the current quarter exceeded the projection, inventories of autos would probably fall short of the projection. In fact, auto production had not come up to the expected volume in July, and inventories had not increased in line with the third-quarter projection.

Mr. Morris observed that he was particularly troubled by the behavior of short-term interest rates in the staff projections. In view of past business cycle experience, he found it difficult to believe that commercial paper rates could remain in the range of 11 to 12 per cent at the same time that the unemployment rate rose above 7 per cent. Nevertheless, he recognized that such a combination could occur in the present circumstances. If it did, the consequences for the economy and for the Federal Reserve System would be serious.

Continuing, Mr. Morris said one consequence would be a wave of business failures next year larger than any witnessed since the 1930's. Businesses would face a much more difficult problem in attempting to adapt to high interest rates when economic activity was contracting than when it was expanding. Another consequence that appeared inevitable was the development of an overwhelming demand within the Congress for the allocation of credit. Both of those consequences suggested that the System ought to be engaged in some intense forward planning.

Mr. Balles remarked that the projections of the San Francisco Bank, which had just been revised, suggested that a modest rate of growth in real GNP would develop before the end of this year and that both the rate of unemployment and the rate of inflation would be lower than suggested by the

Board staff projections. He asked whether, as he thought, the latter projections were among the most pessimistic of those available.

Mr. Partee said he believed that was the case. He would point out, however, that many of the private forecasts were undergoing revision, and it was likely that many would be revised downward. In any case, other forecasters were not constrained with respect to their monetary policy assumptions, as was the staff. Whereas the staff assumed maintenance of growth in M_1 at a rate close to the Committee's longer-run targets, other forecasters might assume that the weakness in the economy would lead to a more expansive monetary policy. They might also be inclined to assume a higher degree of fiscal stimulus. With respect to the San Francisco Bank's projection of an upturn in real GNP before the end of the year, he was very skeptical.

Mr. Balles remarked that the staff projections of real GNP suggested a recession that would be the worst of the postwar era, and given that, he inquired about the reasons for the high rate of inflation that was also projected.

Mr. Partee replied that the projected rate of inflation essentially was based on the expectation of a continuation of wage increases large enough to compensate workers for the substantial rise in prices that had already occurred. Most businesses would tend to price on a cost-plus basis; while profit margins would decline, they would not decline sufficiently to offset the rise in unit labor costs. It was possible that some businesses would be forced to lower prices and accept losses, but the projected weakness in economic activity was not great enough to induce distress liquidation of inventories on the scale that occurred, for example, in 1920-21, with its downward pressure on prices.

Mr. Gramley added that a moderate decline in prices of industrial raw materials was reflected in the price projections, but as Mr. Partee had said, unit labor costs would exert very strong upward pressures on prices. Over the six quarters from the second quarter of this year to the last quarter of 1975, unit labor costs were projected to rise at an annual rate of 8-1/4 per cent, a rate considerably higher than in the recession of 1969-70.

Mr. Holland commented that he had found the staff projections and their implications instructive and useful in his own thinking about the economic situation and outlook. At the same time, it seemed important to emphasize that in no sense did they represent objectives that the Committee was adopting.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of System Open Market Account covering domestic open market operations for the period July 16 through August 14, 1974, and a supplemental report covering the period August 15 through 19, 1974. Copies of both reports have been placed in the files of the Committee.

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

> In the month since the last meeting of the Committee, the severe tensions and extreme caution that brought some sectors of the capital market to a near standstill in early July have abated. Somewhat more normal flows of funds have resumed, although considerable caution remains. Underlying the abatement of extreme tension, I believe, is the fact that a number of market participants who had prepared for "the worst" found that Armageddon was not yet here, and they began to climb out of their shells. The continuing caution shows clearly, though, in the sustained high interest rates, and the necessity of many borrowers to reduce the size and maturity of their offerings as investors regard the conquest of inflation as still a long way off. This attitude also seems to underlie the deteriorating stock market, which experienced some brief euphoria as it became clear that a change of Administration would take place, but then sagged back once the anticipated change in political leadership occurred and grim economic realities were faced again.
>
> System operations added to nonborrowed reserves early in the period, helping to set a climate in which the Federal funds rate eased back from the 13 to 14 per cent range of early July to around 12 to 12-1/2

per cent. Reserves were added through purchases of agency issues and acceptances in the market, purchases of bills from foreign accounts, and temporary injections with repurchase agreements. About midway through the interval, with market factors providing reserves in size, the Desk changed direction and took out reserves through matched sale-purchase transactions with the market and also with a foreign account that had some temporary funds to invest. The Desk also sold some bills outright to foreign accounts. In the final days of the period, reserve injections were needed again to meet reserve growth and money market objectives, and the Desk made large purchases of bills in the market, bought additional acceptances, and also made sizable repurchase agreements.

Monetary and reserve growth developments were about in line with Committee objectives during the period. Early in the interval, it was estimated that M_1 would grow at a rate about midway in the specified 2 to 6 per cent range in the 2 months ending in August, while more recently a rate around 3 per cent has been estimated. Estimates of M_2 and RPD expansion also edged lower, in line with the Committee's desire for moderated growth.

A highlight of financial market developments during the interval was the Treasury's successful refunding of its August note maturity through the auction of $4 billion in 9 per cent 33-month and 6-year notes and $400 million in reopened 25-year bonds. Noncompetitive bidders, attracted by the unprecedented 9 per cent coupon, took an unusually heavy proportion of the notes--some $2.1 billion. Another $1,150 million went to dealers, but they subsequently distributed about $450 million, generally at prices somewhat above those paid in the auction. In the bond auction, dealers initially took down over $200 million, but this was subsequently worked down to around $100 million, largely at prices a bit under the auction average. At present the dealers do not seem to feel seriously burdened with their holdings of about $800 million in the three new issues, although this mood could change if secondary distribution slowed and the securities had to be carried for long at current high financing costs.

Market supplies of Treasury bills are also considerably larger than a month ago, reflecting Treasury financing operations and a let-up in customer demand. This has produced a rise in bill rates of 100 basis points or so since mid-July despite the downward drift in the Federal funds rate. Three- and six-month bills were auctioned yesterday at average rates of about 8.85 and 8.90 per cent, compared with 7.70 and 7.88 per cent the day before the last meeting.

As for new financing, the Treasury may need up to about $2 billion of additional cash by early September, apart from picking up $200 million a week in the regular bill auctions. This new borrowing could take the form of bills or some other short-term issue and should not pose much difficulty for the market.

At the last meeting, some concern was expressed about the adequacy of supplies of Government and other securities in the market to meet System needs to provide reserves--particularly given the competition of heavy buying by foreign accounts as they acquired dollars and by private investors as they sought the safest haven in a troubled market. For the moment, this is not a problem. The Treasury has enlarged the total supplies, foreign appetites have not developed as quickly as had been expected earlier, and domestic investors have not been so driven in their desire for quality. The situation could change again fairly quickly, however, particularly through an influx of foreign investment orders, so that the contingency planning called for at the last meeting is still in order, and it is under study by the staff committee designated for that purpose.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period July 16 through August 19, 1974, were approved, ratified, and confirmed.

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

I would like to make just a few comments on current financial conditions as they pertain to the Committee's consideration of monetary strategy in the weeks ahead.

Financial markets remain quite sensitive to changes in the thrust of monetary policy and to other exogenous shocks. Yield spreads indicating risk premia are less wide than at their peaks in July, but they are still large as compared with historical experience. Moreover, dealer positions in U.S. Government securities have risen substantially in the aftermath of the recent rash of Treasury financings, moving from a net short position in mid-July to a long position of around $3 billion currently. And deposit flows to thrift institutions were under severe pressure in July and early August.

This sensitivity suggests that any near-term, significant-seeming rise in the Federal funds rate would be likely to interrupt the somewhat better flow of credit through markets that has recently emerged. This better flow, I might add, has been confined to securities markets. Mortgage markets remain very weak, with rates continuing to rise and with new and outstanding commitments at savings and loan associations continuing a decline that began around mid-spring. A return to higher Federal funds rates--accompanied as it would be by considerably higher Treasury bill rates than prevailed in July--would undoubtedly erode seriously further the position of thrift institutions.

In view of the weak business outlook and recent moderation in the monetary aggregates, a decline in the Federal funds rate is probably more on the market's mind than is a rise. The market remains quite cautious in its assessment of the course of monetary policy, however, and does not at the moment appear inclined to move rates generally well ahead of the current stance of policy as reflected in the money market. Therefore, I would doubt that a small decline in the funds rate over the next few weeks--say to the 11-3/4 per cent mid-point of the alternative B[1] range--would set off a significant easing of interest rates generally. A more noticeable drop to around the 11 per cent area probably would be more likely to; it could trigger a decline in the prime loan rate as commercial paper rates declined further, perhaps by one-half percentage point or so.

A further drop in short rates would tend to moderate pressures on thrift institutions and the mortgage market, but I would not expect any very significant improvement to occur over the next few weeks from a decline in the funds rate to, say, the 11 per cent area. Such a decline would still leave over-all market interest rates relatively high and would not likely be associated with very robust deposit inflows at thrift institutions. Any recovery in flows would take time to develop, and it would take even more time before thrift institutions felt comfortable enough to ease their commitment policies.

As a final point, I would add that some modest easing in the funds rate is unlikely to be taken as a signal that the Federal Reserve is weakening in its determination to combat inflation so long as it occurs at a time when money growth is sluggish and the economic outlook is weak--as has been the case in recent weeks.

In sum, under current market circumstances, I would offer the judgment that market reaction to a modest easing of the funds rate would be less pronounced than market reaction to a modest tightening, partly because the latter would come as a surprise to market observers.

Mr. Black remarked that for some time he had been concerned that the rapid rise in short-term interest rates might result in too much of a slowing down of growth in the aggregates, and he was puzzled that the projections in the blue book[2]

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

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

suggested that monetary growth would be well sustained over the rest of this year. He asked what the rationale was for those projections and also what the explanation might be for the slowing down of growth in July.

In response, Mr. Axilrod commented that the relationship between the funds rate and monetary growth had been altered slightly so that the Committee's longer-run target of 5-1/4 per cent for M_1 was associated under alternative B in the latest blue book with a Federal funds rate range whose mid-point was one-quarter of a percentage point lower than in the last month's blue book. The basic reason for the projection of fairly substantial growth in the money stock over the balance of the year, however, was the rather high rate of growth projected for nominal GNP in the third and fourth quarters. With nominal GNP projected to rise at an annual rate of 8.5 per cent over the two quarters, reflecting the projected rise in prices, the public's demand for cash was expected to expand in the effort to finance transactions and to maintain the real value of balances.

Concerning the July slowdown in M_1 growth, Mr. Axilrod remarked that he had not been able to uncover any special explanatory factors; for the time being, he had to regard it as an aberration in behavior that did not reflect a long-lasting shift in money demand. The rate of growth strengthened in early August, and for August and September growth was projected to be close to the trend rate. However, he would not discount the possibility that weakness in monetary growth would persist for a while. If it persisted for long, it would raise the question of whether it reflected weakness in the economy rather than a temporary, self-correcting variation.

Mr. MacLaury noted that under alternative B, the projected annual rate of growth in M_1 was 6.8 per cent in September, and he asked whether that rate represented merely a bouncing back from the low rate in July or some more basic forces.

Mr. Axilrod replied that the projected September rate reflected a continuation of the weekly pattern of growth as it was resumed in early August. That pattern also allowed for the staff's judgment that the July aberration on the low side would be made up by an aberration on the high side, since the basic economic projection gave no reason for altering the underlying trend in money demand.

After recessing briefly, the Committee reconvened with limited staff attendance. In addition to the members, Presidents MacLaury, Morris, Eastburn, and Balles, and First Vice Presidents Baughman, Leonard, and Plant, the following were present: Messrs. Broida, Altmann, O'Connell, Partee, Axilrod, Bryant, Coombs, Sternlight, and Coyne.

Chairman Burns remarked that he had been late this morning because, at President Ford's invitation, he had attended a special meeting of legislative leaders. At that meeting, the President indicated a firm resolve not to seek direct controls over wages and prices. However, the President hoped that a new agency like the Cost of Living Council would effectively monitor wage and price increases and that it would exert some influence on the size of those increases. Concerning the Federal budget, the President's objective was to work toward an expenditure total of under $300 billion for fiscal 1975. That would be a difficult task; the budget, as it had been submitted, called for expenditures of $305 billion, and various measures being considered in the Congress could easily push the total up into a range of $310 to $315 billion. However, the President indicated that using his authority under Title X of the Congressional Budget and Impoundment Control Act of 1974--which, in the Chairman's view, contained provisions that were roughly equivalent to an item veto--he would work with the legislative leaders to bring the total down under $300 billion. Finally, the President outlined his plans and asked the legislative leaders for their recommendations concerning the summit meeting on inflation that had already been announced. Six to ten sub- or pre-summit meetings were being planned. The summit meeting itself, at which plans would be formulated to restore some approximation to general price stability, was likely to be held in late September or early October.

The Chairman observed that the country was passing through a difficult period with an unusual number of uncertainties. Therefore, he thought it would be advisable for the Committee to have extended policy deliberations at an early date. He was giving consideration to advancing the date of the next meeting a week or ten days from that tentatively scheduled, and asked the members to keep in mind the possibility that the meeting would be called for September 10 or 11 or perhaps even a day in the preceding week. With respect to today's meeting, the Committee would have to return in the afternoon if it were unable to conclude its deliberations by

1:00 p.m., because he was scheduled to return to the White House for a meeting with the President.

Mr. Eastburn asked whether the Chairman could say anything about the probabilities that the new Administration would propose specific programs to deal with unemployment, housing, and other special problems.

Chairman Burns replied that the unemployment and housing situations were on the Administration's agenda for early discussion, but he did not know the direction of the President's thinking at this time. Clearly, the President had those problems on his mind, and his attention also was being directed to other problems--for example, the plight of the electric utility industry, which in its way was as serious as the plight of the home building industry. On the international side, the price of oil was a serious problem that had been neglected by the U.S. Government as well as by others.

Mr. Mitchell observed that in light of the Chairman's remarks the Committee might well temporize with its policy posture and for the period until the next meeting continue its policy essentially without change. He believed alternative B was consistent with such a course, and he urged the members to adopt that alternative. Inflation obviously was a major concern of the new

Administration, and that provided promise of relieving the System of some of the responsibility that it had been assuming in the fight against inflation. However, the facets of Administration policy were not yet known, and by the time of the next meeting, the Committee might be in a better position than it was today to judge the policy's effectiveness.

Continuing, Mr. Mitchell remarked that the staff presentation this morning also argued for a temporizing posture. He had found the presentation disconcerting in that the projections did not seem to be internally consistent. In his view, the decline in the stock market, the deflation and near collapse of the housing industry, and the secondary effects of those developments were not adequately translated into weakness in real economic activity and into the rise in the rate of unemployment. He recognized, of course, that views on the economic outlook differed a great deal and that some members of the Committee saw buoyancy developing already.

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

Mr. Partee said he felt very strongly that the time had come to raise the longer-run targets for growth in the aggregates and that they should be raised very shortly, if not today. Given the downward revision in the rate of monetary growth over the first half of the year and the low rate in July, there no longer was an excess in the growth rate that needed to be offset. Consequently, the Committee could accept a higher rate of monetary expansion than it had been targeting. Interest rates should be on a downward course in the period ahead, although he would not like to see them drop sharply. One way for the Committee to temporize pending more extended deliberations of policy would be to specify a funds rate range close to the 10-3/4 to 12-3/4 per cent range of alternative B and to instruct the Desk to move the rate--which was about 12-1/4 per cent this morning--downward within that range over the coming period.

Chairman Burns said he agreed that the longer-run targets ought to be reconsidered. However, the issues should be deliberated thoroughly, and if there was sentiment to undertake such deliberations today, the Committee would have to continue its meeting in the afternoon. His own feeling about the policy decision today was much like Mr. Mitchell's. Therefore, he would favor the specifications of alternative B, except that he would narrow the range for the Federal funds rate while retaining the 11-3/4 per cent mid-point. In brief, he would specify a range of 11 to 12-1/2 per cent for the funds rate and an August-September range of 4-3/4 to 6-3/4 per cent for M_1.

Continuing, the Chairman observed that such specifications would imply a slight downward shading of the funds rate; the 11-3/4 per cent mid-point of the range--which was theoretically consistent with the specifications for the aggregates--compared with the 12-1/4 per cent mid-point of the range specified at the last meeting. He was a little unhappy that the funds rate was not now down to 12 per cent--where he had hoped it would be--and he would expect the Desk to move it down gradually toward 11-3/4 per cent. He would avoid a quick reduction in the rate, however, because the market might interpret it as a rapid move in an easing direction.

Mr. Hayes remarked that he agreed that the longer-run targets should be reconsidered at some point, but he believed that it would be premature to reach any decision concerning them today. He also agreed with Mr. Mitchell's statement that the Committee might well temporize with its policy posture at this time. In his view, however, to temporize meant to hold the present position, and he would be reluctant to lower the mid-point of the funds rate range by as much as a half of a percentage point, given the sensitivity of the market. He would not want to encourage market participants in their expectations of some easing in policy. Accordingly, he would retain both the long-run and the short-run specifications adopted at the July meeting; specifically, he would favor an M_1 range of 2 to 6 per cent for the August-September period and the funds rate range of 11-1/2 to 13 per cent for the period until the next meeting. In view of the great uncertainty about the economic policies of the new Administration, he saw no reason for raising the range for M_1 or for reducing the range for the funds rate in accordance with alternative B.

Mr. Mitchell remarked that he had no objection to specifications similar to those adopted at the last meeting.

Chairman Burns said he agreed that the outcome of the Administration's consideration of economic policies was uncertain, and uncertainties with respect to the Federal budget were likely to continue for some time. On three or four occasions in 1969, when he was at the White House, he had succeeded in obtaining a firm Presidential decision to cut $3 or $4 billion from the budget, only to see the decision reversed just a few weeks later and several billions added to the budget. At this time, however, there was a strong desire across the country to get Federal spending under control, and such a mood was reflected in the Congress. Large numbers of Congressmen on both sides of the political aisle now were willing to face up to the need for cutting the budget.

Mr. Hayes remarked that he respected the Chairman's reading of the mood of the country and of the Congress. However, the willingness to consider economizing on total expenditures would be accompanied by considerable pressure to raise spending for specific programs. As a result, it would be difficult to reduce the net stimulative effect of the budget, which he regarded as too great. Consequently, he believed that this would be the wrong time to ease monetary policy even to the degree suggested by alternative B. As he had said, he would prefer to hold the line by continuing the specifications adopted at the last meeting. And he would adopt the language of alternative B--couched in terms of either money market conditions or the aggregates.

Mr. Sheehan noted that, according to their remarks earlier this morning, Messrs. Balles and Leonard expected economic activity to be stronger than suggested by the staff projections. He asked if they would indicate the basis for their expectations.

Mr. Balles said his staff, using essentially the same model used by the Board's staff, had introduced some different exogenous variables which had resulted in somewhat less weakness in three major areas of expenditures: residential construction, business fixed investment, and consumer durable goods. The differences were small, but they resulted in a low rate of growth over the balance of this year rather than a further decline. In periods such as this one, it seemed to him, weakness tended to be concentrated in a few sectors, such as housing, and was easily identified, whereas strength often was more dispersed and was more difficult to detect.

Mr. Leonard remarked that the staff at the St. Louis Bank based its assessment of greater strength in real GNP than suggested by the green book projections in large part on a judgment that the procedures for deflating nominal GNP were not reliable in the recent and current periods. There were reasons for believing that in the 1972-73 period when price controls were in effect, prices actually rose more and real output less than indicated by the GNP statistics. Over the first half of this year, with price controls no longer in effect, it was likely that the rise in prices was being overstated and, consequently, that real GNP was stronger than indicated by the official figures. In view of that appraisal, he supported alternative B.

Mr. Wallich observed that none of his former forecasting colleagues with whom he had checked foresaw a disastrous degree of weakness in economic activity and most had projections that were a little stronger than those of the staff. The principal way in which a more optimistic view of the outlook could be taken was to reject the recent revision in the inventory statistics and to take the position that there would not be a cycle of inventory reduction. That would be the greatest element of strength that one could introduce into the situation.

Mr. Eastburn commented that he was in sympathy with Mr. Mitchell's view of the present uncertainties concerning both the projections and Administration policies. An important uncertainty involved the projections. Some arguments might be advanced for a stronger forecast of real GNP than presented by the staff, but he felt that the risks were higher on the side of greater weakness. That judgment would lead him in the direction of a more liberal monetary policy along the lines of alternative A. On the other hand, if the Administration vigorously pursued programs to affect specific sectors of the economy, monetary policy could remain more restrictive.

Continuing, Mr. Eastburn said he was inclined toward Mr. Partee's view that the Committee should raise its longer-run targets for growth in the aggregates, although he would be willing to postpone a decision on the targets for a time. One way of meeting the problem today would be to widen the August-September range for M_1 under alternative B to provide for the possibility of more rapid growth than was now thought likely, consistent with a reasonable and orderly change in the Federal funds rate. Thus, the 2-month range might be 4-3/4 to 7 or to 7-1/4 per cent.

Mr. Kimbrel observed that he was encouraged by the present situation, because it appeared that monetary policy was beginning to have some bite. At the same time, inflation continued to be a serious threat. Recent wage settlements had not yet worked their way through the cost-price structure, and upward price pressures would be forthcoming. Therefore, it was important to capitalize on the present mood of the country and of the Congress to work to contain inflation. Accordingly, he would be reluctant to pursue a more accommodating policy, as suggested by the targets of alternative B. For the Federal funds rate, he would prefer a somewhat more restrictive range than that proposed by the Chairman--specifically, a range of 11-1/2 to 12-1/2 per cent, rather than 11 to 12-1/2 per cent. In his view, a decline in the rate much below 11-3/4 or 11-1/2 per cent would lead the market to conclude that the System was moving to a more accommodative policy, and that would be unfortunate at this time.

Chairman Burns commented that he could be quite happy with the range for the funds rate suggested by Mr. Kimbrel. It permitted a very slight downward shading of the rate, depending on the course of growth in the aggregates.

Mr. Hayes remarked that he too could accept that range for the funds rate.

Mr. Holland observed that there were good arguments for pursuing a steady policy over the next few weeks, pending the Committee's fuller discussion of the situation. Although it was important that the new Administration's economic program was in the process of development, that was not the only reason. The economy itself was providing daily signals, and with each week that went by, more would be learned about the situation. Also, the monetary and credit aggregates were behaving differently now from a few months ago, and the atmosphere in financial markets and financial institutions was different. All of that needed to be taken into account.

Continuing, Mr. Holland said he did not believe there was any basis for making an abrupt change in policy at this time, and there were risks concerning the way an abrupt shift would be perceived by financial institutions. However, maintaining a steady posture did not mean holding the Federal funds rate in the 12-1/4 to 12-1/2 per cent range. Given the amount of tension already generated in the banking system, developments had reached a stage, as they often had in the past, when holding a given funds rate would involve a further grinding and cumulative pressure of credit tightness through the financial system. Therefore, while he favored a steady posture, he believed that the funds rate should drift down gradually. He would like to see it drift down to 11-3/4 per cent, assuming that the aggregates grew within their specified ranges. Such a downward drift, in his view, would be consistent with the reserve flows and the kind of atmosphere in credit markets that would represent a steady policy.

Finally, Mr. Holland remarked that it would be compatible with such a policy for the Desk to continue relatively aggressive purchases of bankers' acceptances in carrying out its reserve-supplying operations. Such purchases had been useful in recent weeks and ought to be continued in the weeks until the next meeting.

Mr. MacLaury said he doubted that a temporizing posture was appropriate policy at this time. The GNP forecasts had been changed substantially, and the deterioration in the outlook for real GNP--even though accompanied by prospects for a more rapid increase in prices than had been projected earlier--argued against such a policy. The System ought to provide some sort of a signal that it was taking account of the weaker projections of real activity. Although he believed that the risks of further deterioration in activity were no greater than the chances of an upturn, no more evidence of weakness was needed to indicate that some action should be taken now.

Specifically, Mr. MacLaury continued, he would favor specifications half-way between those of alternatives A and B. He would favor raising the longer-run target for M_1 from 5-1/4 to 5-3/4 per cent, but he would be willing to wait until the next meeting to consider that issue. With respect to short-term targets, he would propose an M_1 range of 5 to 7 per cent for the August-September period and a Federal funds rate range of 10-1/2 to 12-1/2 per cent for the period until the next meeting. He would not object to narrowing the funds rate range, but would prefer to have the range centered on 11-1/2 rather than 11-3/4 per cent. He preferred the Chairman's original proposal of 11 to 12-1/2 per cent for the funds rate to the later one of 11-1/2 to 12-1/2 per cent.

Chairman Burns commented that the case for setting the lower limit of the funds rate range at 11-1/2 per cent would be stronger if the Committee were going to meet again in 2 or 3 weeks, rather than in 4 weeks as called for by the tentative meeting schedule. He was strongly inclined to have an early meeting.

Mr. Bucher observed that, while recognizing the uncertainties about the outlook, he believed the staff projections were more plausible than others he had seen. He agreed with Mr. Partee that the time had come for the Committee to give serious consideration to adjusting the longer-run targets for monetary growth. While he would urge the Committee to have its extended discussion of the subject as promptly as possible, he was willing to wait a few weeks.

Chairman Burns asked the members to indicate whether they preferred to consider the longer-run targets and related policy issues at an afternoon session of this meeting or at the next meeting, which he expected would be held at an earlier date than the one tentatively scheduled.

A majority indicated that they favored the latter procedure.

Continuing, Mr. Bucher said he agreed with Mr. Eastburn's suggestion to widen the 2-month range for M_1 under alternative B to provide for the possibility of more rapid growth, and an upper limit of 7 per cent would be acceptable to him. For the Federal funds rate, he preferred a range tending toward that of alternative A, but with some reservations he could accept the 10-3/4 to 12-3/4 per cent range of alternative B. With greater reservations, he could accept the Chairman's original proposal to retain the 11-3/4 per cent mid-point of alternative B and to narrow the range to 11 to 12-1/2 per cent.

Chairman Burns remarked that his own preference was for a Federal funds rate range of 11-1/2 to 12-1/2 per cent for a very brief period. That would provide a little room to shade the rate downward.

Mr. Bucher commented that in considering the funds rate range, he would take into account that the time interval until the next meeting was shorter than usual. He would not want to suggest to the market that a major easing in policy was being undertaken. At the same time, however, he agreed with Mr. Holland's remarks about the degree of monetary restraint now in effect. Therefore, he preferred specifications snaded a little toward alternative A from alternative B, but he could accept the specifications of alternative B as modified by the Chairman.

Mr. Wallich observed that it was very important to avoid giving the impression of an abrupt shift in policy. Such shifts frequently had been made in the past, and they often had turned out to be wrong. At this time, an abrupt change could have very harmful consequences. Thus, it would be desirable to act now; allowing the funds rate to slide down a little would ease the difficult transition without providing an overt signal to the market.

Continuing, Mr. Wallich commented that fundamentally the Committee had to watch the evolution of real GNP. At present, real GNP either was not growing at all or was growing at an inadequate rate, and if the Committee continued on its present policy course, its leeway for future policy would be curtailed. A better performance of economic activity was necessary in order to be able to continue a basically restrictive policy that would build up some slack in the economy. With those thoughts in mind, he would like to see the funds rate come down just a little. If weakness in M_1 continued, he would give more weight to the behavior of the aggregates than to the funds rate, although he would want to be able to reconsider that view. His preference was for the specifications of alternative B, shaded slightly toward those of alternative A. Specifically, he favored an M_1 range of 5 to 7 per cent for the August-September period and a funds rate range of 11-1/2 to 12-1/2 per cent for the period until the next meeting.

Mr. Sheehan remarked that his view of the economic situation was close to the Chairman's. In his judgment, the economy was a little stronger than it might appear to be. At the same time, however, he accepted the staff projections of a continuing decline in real GNP, because he believed that businessmen, as they became aware of the weakness, would begin to cut their inventories and to make other adjustments.

Continuing, Mr. Sheehan observed that the System found it difficult to make policy changes because of the market's great sensitivity to System actions. It would be better if the market were both more uncertain about and less sensitive to actions of the System, so that policy changes could be taken in small rather than giant steps. He preferred smooth, gradual changes in policy. Over the long run, the market might become less sensitive if the System made more frequent, small adjustments in its policy posture. Consequently, he favored a slight further decline in the funds rate over the period until the next meeting and could accept the Chairman's proposal. At the next meeting, he would be prepared to make another slight adjustment in either direction, depending on the situation at that time.

Mr. Clay commented that he would like to see a monetary policy that would foster conditions leading to a reduction in the rate of inflation at the same time that it would provide sufficient liquidity to prevent major disruptions in financial markets. In thinking about the problem prior to receiving the blue book, he had come out with specifications very close to those of alternative B--namely, a 5 per cent longer-run target for M_1 and a 4-1/2 to 6-1/2 per cent August-September range, along with a 11-1/4 to 12-3/4 per cent range for the Federal funds rate. Consequently, he could accept the Chairman's proposal.

Mr. Morris said he believed that the time for a major turn in monetary policy was approaching. Consequently, he shared the Chairman's desire to hold an early meeting, but an afternoon session of today's meeting would not serve the purpose because the information available at present was inadequate. For example, the Committee needed to know whether the July slowing of growth in the aggregates was merely an aberration or was a result of underlying economic forces. As for the staff projections, he found them reasonable, given the information available now. One implication of those projections, it seemed to him, was that the Committee had to conduct monetary policy so as to avoid risking an error on the side of still greater weakness in economic activity; the projected real GNP probably represented the maximum sacrifice that was socially acceptable in the fight against inflation.

Mr. Morris commented that a few weeks from now the Committee would be in a better position to determine whether it would be necessary to seek lower interest rates in order to achieve an acceptable rate of monetary growth. Because a _prima facie_ case could already be made for such action, he favored a slightly larger decline in the Federal funds rate over the next few weeks than the Chairman appeared to be suggesting, and he preferred the 11 to 12-1/2 per cent range.

Mr. Balles observed that while his expectations for the economy were less pessimistic than those of the Board's staff, he foresaw weakness. Nevertheless, he was concerned that the

Committee would give up the gains made since spring in slowing monetary growth to a rate that he would regard as noninflationary. He recognized that high interest rates were creating serious problems in major sectors of the economy, but until inflationary expectations were reduced, interest rates would not decline. Consequently, he would be loath to change the Committee's longer-run targets until there was solid evidence of a reduction in those expectations. For the period until the next meeting, he favored alternative B, with the Chairman's proposed modification of the funds rate range. Such specifications would allow for a slight downward shading of the funds rate while growth in the aggregates would be maintained within acceptable ranges.

Mr. Black remarked that he was in agreement with the Chairman on the specifications the latter had proposed, including a funds rate range of 11-1/2 to 12-1/2 per cent.

Chairman Burns suggested that the Committee consider first the language of the directive. The final sentence of the first paragraph of the staff's draft noted that "The new Administration has indicated that it will give high priority to combating inflation and that it will convene a summit conference of the nation's economic leaders to that end." He recommended that, if retained, the sentence be made a separate paragraph. On that understanding, he asked the members to indicate whether they preferred to retain the sentence.

A majority indicated that that was their preference.

The Chairman then asked whether there were any objections to adopting the language of alternative B for the operational paragraph.

No objections were raised to that alternative.

Chairman Burns observed that at recent meetings the Committee had decided to widen the short-run ranges of tolerance for the aggregates by reducing the lower limits because of a willingness to accept the lower rates of growth for a time in the event that they developed, given the range specified for the Federal funds rate. Assuming for the moment that the Committee adopted the specifications of alternative B, he asked the members to indicate informally whether they wished to reduce the lower end of the short-run range for M_1 to 2 per cent, as had been suggested by Mr. Hayes, and to adjust the ranges for the other aggregates accordingly.

A majority indicated that they preferred not to reduce the lower end of the ranges.

Chairman Burns said he thought, on the basis of the discussion, that the following suggestions might be acceptable to the Committee. He proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs, as altered earlier, and alternative B for the operational paragraph. It would be understood that the 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, 6-1/2, and 6-1/2 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the August-September period would be 7-3/4 to 9-3/4 per cent for RPD's, 4-3/4 to 6-3/4 per cent for M_1, and 5-1/2 to 7-1/2 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 11-1/2 to 12-1/2 per cent.

Mr. Black asked whether the Chairman would expect the Manager to move the funds rate down toward 11-3/4 per cent, as he had indicated earlier when proposing a funds rate range of 11 to 12-1/2 per cent.

Chairman Burns replied that he would like to see the funds rate move a shade under 12 per cent, into a range of 11-3/4 to 12 per cent, but he would not like to see that happen in just a day or two.

Mr. Eastburn asked Mr. Sternlight how the Desk would react if it appeared that M_1 would grow in the August-September period at a rate substantially above the 6-3/4 per cent upper limit of the range, or even at a rate close to that upper limit.

Mr. Sternlight replied that if M_1 appeared to be growing at a rate substantially above 6-3/4 per cent, he would--in accordance with Committee procedures--promptly notify the Chairman with a view to obtaining supplementary instructions. In the event that M_1 appeared to be growing at a rate close to 6-3/4 per cent, the Desk would aim for a funds rate in the upper part of the 11-1/2 to 12-1/2 per cent range.

Chairman Burns remarked that it might be necessary to consult with the Committee if M_1 appeared to be growing at a rate near the top of the range, because he believed it would be unwise to maintain the Federal funds rate close to 12-1/2 per cent.

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

The information reviewed at this meeting suggests that real output of goods and services is changing little in the current quarter, following the first-half decline, and that price and wage increases are continuing large. In July industrial production was unchanged from the May-June level, and nonfarm payroll employment declined further. The unemployment rate edged up to 5.3 per cent. Wholesale prices of farm and food products rose sharply, after having declined for 4 months, and increases among industrial commodities continued widespread and extraordinarily large.

The new Administration has indicated that it will give high priority to combating inflation and that it will convene a summit meeting of the nation's economic leaders to that end.

In recent weeks the dollar has appreciated somewhat further against leading foreign currencies. U.S. bank lending to foreign borrowers, especially in Japan, has apparently continued large, but inflows of foreign capital, particularly from oil-exporting countries, have also been large. The foreign trade deficit, although smaller in June than in May, widened substantially from the first to the second quarter as the value of petroleum imports increased.

The narrowly defined money stock rose only slightly in July, after having grown at an annual rate of 6 per cent over the first half of the year. Net inflows at banks of time deposits other than money market CD's slowed somewhat in July, and deposit experience at nonbank institutions worsened materially in July and early August. Growth in business loans and in total bank credit was substantial in July, although the pace of expansion slackened after the early part of the month. To finance loan growth, banks reduced their holdings of Treasury securities and increased their outstanding volume of large-denomination CD's by substantial amounts. Interest rates on most private market instruments have declined a little in recent weeks, and in association with some easing of tensions in financial markets, yield spreads between prime- and lower-quality issues--which had widened sharply--have narrowed. Yields on Government securities, particularly Treasury bills, have increased, in part because new Treasury offerings relieved a market shortage of such securities.

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 achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

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

It was agreed that the next meeting of the Committee would be subject to the call of Chairman Burns.

Secretary's note: On August 22, 1974, the members were advised that the Chairman had called for a meeting of the Committee to be held on Wednesday, September 11, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida
Secretary

ATTACHMENT A

August 19, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on August 20, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services is changing little in the current quarter, following the first-half decline, and that price and wage increases are continuing large. In July industrial production was unchanged from the May-June level, and nonfarm payroll employment declined further. The unemployment rate edged up to 5.3 per cent. Wholesale prices of farm and food products rose sharply, after having declined for 4 months, and increases among industrial commodities continued widespread and extraordinarily large. The new Administration has indicated that it will give high priority to combating inflation and that it will convene a summit meeting of the nation's economic leaders to that end.

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

OPERATIONAL PARAGRAPH

tive A

To implement this policy, while taking account of develop- n domestic and international financial markets, the Com- seeks to achieve bank reserve and money market conditions ent with somewhat faster growth in monetary aggregates s prevailed over recent months.

ive B

To implement this policy, while taking account of ents in domestic and international financial markets, ittee seeks to achieve bank reserve and money market ns consistent with moderate growth in monetary aggre- er the months ahead.

ive C

To implement this policy, while taking account of nts in domestic and international financial markets, ttee seeks to achieve bank reserve and money market s consistent with relatively slow growth in monetary s over the months ahead.

ATTACHMENT B

August 20, 1974

Points for FOMC guidance to Manager in Implementation of directive		Specifications (As agreed, 8/20/74)
A. Longer-run targets (SAAR): (third and fourth quarters combined)	M_1	5-1/4%
	M_2	6-1/2%
	Proxy	6-1/2%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (August-September average):		7-3/4 to 9-3/4%
2. Ranges of tolerance for monetary aggregates (August-September average):	M_1	4-3/4 to 6-3/4%
	M_2	5-1/2 to 7-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		11-1/2 to 12-1/2%
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.