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 19, 1975, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Volcker, Vice Chairman
Mr. Baughman
Mr. Bucher
Mr. Coldwell
Mr. Eastburn
Mr. Holland
Mr. Jackson
Mr. MacLaury
Mr. Mayo
Mr. Mitchell
Mr. Wallich

Messrs. Balles and Winn, Alternate Members of the Federal Open Market Committee

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

Mr. Broida, Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist

Mr. Holmes, Manager, System Open Market Account
Mr. Pardee, Deputy Manager for Foreign Operations

Mr. Coyne, Assistant to the Board of Governors
Mr. Brenneman, Special Assistant to the Board of Governors

Chairman Burns said he wanted to get the reactions of the FOMC to a suggestion that Congressman Rousselot of California had made during House Banking Committee hearings at which he (Chairman Burns) had testified on July 24. Mr. Rousselot had proposed that, in order to dispel the widespread impression that the FOMC was unduly secretive, members of the House Banking Committee, on a rotating basis, attend meetings of the FOMC for about a year, with perhaps two Congressmen attending each meeting. He had agreed to transmit Mr. Rousselot's suggestion but had said he would recommend against it. He had proposed as an alternative that members of the House Banking Committee and of the FOMC hold an informal "bull session" on matters of common interest.

After discussion, the Committee agreed that it would not be desirable to accept Congressman Rousselot's suggestion. A number of members expressed the view that one or more informal meetings with Congressmen could be helpful in improving communications between the FOMC and the Congress, and various suggestions were made with respect to possible arrangements. The Chairman noted that he planned to discuss the question further with Mr. Rousselot, and the Committee agreed that decisions with respect to any informal meeting with members of the House Banking Committee should be left to Chairman Burns.

Mr. Brenneman then left the meeting and the following staff members entered:

Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. Guy, Deputy General Counsel

Mr. Gramley, Economist (Domestic Business)
Messrs. Bryant, Green, Kareken, Reynolds, and Scheld, Associate Economists

Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mr. Struble, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Rankin and Leonard, First Vice Presidents, Federal Reserve Banks of Richmond and St. Louis, respectively

Messrs. Eisenmenger, Parthemos, Jordan, Doll, and Sims, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, St. Louis, Kansas City, and San Francisco, respectively

Messrs. Hoskins and Hocter, Vice Presidents, Federal Reserve Banks of Philadelphia and Cleveland, respectively

Messrs. Sandberg, Thunberg, and Cox, Assistant Vice Presidents, Federal Reserve Banks of New York, New York, and Atlanta, respectively

Chairman Burns welcomed Mr. Paul A. Volcker, who had recently become President of the Federal Reserve Bank of New York, to his first meeting of the Federal Open Market Committee.[1/] Noting that the position of Vice Chairman had been vacant since the retirement of Mr. Hayes, the Chairman suggested that the Committee might wish to name Mr. Volcker to that post.

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

By unanimous vote, Paul A. Volcker was elected Vice Chairman of the Federal Open Market Committee, effective immediately, to serve until the election of his successor at the first meeting of the Committee after February 29, 1976, with the understanding that in the event of the discontinuance of his official connection with the Federal Reserve Bank of New York he would cease to have any official connection with the Federal Open Market Committee.

By unanimous vote, the Committee ratified the action taken by members on August 6, 1975, increasing from $2 billion to $3 billion the dollar limit on System Account holdings of certificates purchased directly from the Treasury, specified in paragraph 2 of Authorization for Domestic Open Market Operations, for the period through the close of business August 19, 1975.

Mr. McWhirter, Associate Director of the Board's Division of Federal Reserve Bank Operations, entered the meeting.

Chairman Burns noted that a report dated August 14, 1975, of an examination of the System Open Market Account made by the Board's staff as at the close of business April 25, 1975, had been distributed to the Committee on August 15, 1975.[1/] It was his impression from reviewing the report that the examiners had found no significant problems. He asked whether the members had any questions.

Mr. Mitchell noted that, according to the report, losses had been incurred on foreign exchange transactions totaling about $34

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

million in 1974 and $47 million in 1973. However, no information was provided regarding the nature of the losses or the reasons for them. He wondered, for example, whether they had been distributed more or less evenly throughout the years in question.

Mr. McWhirter replied that the losses were not distributed evenly. As indicated in the report, from January 1 through April 25 of this year there were interest earnings of $35,000 and a net loss of about $1.7 million on foreign exchange transactions. The loss experience in the early months of 1974 was similar, so that the bulk of the 1974 losses was incurred over the remainder of the year.

In response to a question by the Chairman, Mr. Pardee observed that the losses in question arose in connection with the swap drawings that had been outstanding for a long period--since mid-1971--and not from current operations.

Mr. Mitchell noted that the report contained considerably more detail on profits and losses in domestic security operations than in foreign exchange operations; an outside observer might well conclude that the information presented on the latter subject was inadequate. He would have preferred to find data indicating when within the period covered the losses had occurred and what currencies were involved. He did not necessarily mean to be critical of the examination of the Account itself; his comments were directed solely to the scope of the report made to the Committee.

Mr. Volcker said he might mention a related matter about which he had been concerned for some time: the practice of reflecting gains and losses in the System's accounting records only at the time they were realized. He wondered whether that was an appropriate and conservative accounting procedure. There was no need to deliberate on the question today, but at some point it would be useful to consider adopting an accounting procedure under which gains and losses were recorded on a more current basis.

Mr. Holmes remarked that he had been troubled by the same question. He had discussed it with the Board's staff on several occasions and recently had asked the Accounting Department of the New York Bank to develop recommendations.

Mr. Holland said he agreed that the matter should be pursued, particularly in light of the System's exposure to losses and of the losses actually incurred in recent years. It would also be desirable at a proper time to consider whether some provision for loss reserves should not be included in the System's balance sheet, given the inevitability of some losses in operations of this kind.

Chairman Burns remarked that while Mr. Holland's suggestion was a useful one it might be difficult to carry out properly because of the need for an economic, as well as an accounting, analysis of gains and losses. For example, a purely accounting analysis of the System's operations would not reveal that the System's losses on long-outstanding swap drawings were small relative to the gains the Treasury had made on related operations during the same period. The need to provide an economic complement to the accounting figures should be kept in mind if a new accounting system was instituted.

Mr. Coldwell recalled that the examiners had found a number of problems in an earlier examination, discussed by the Committee in January 1974. He asked whether those problems had been resolved.

Mr. McWhirter replied that there were no unresolved problems at the time of the latest examination. While accounting errors had been made between the two latest examinations, the management's procedures and internal auditing were sufficient to detect such errors within 3 to 5 days, and all errors had been corrected by the time of the second examination. The Bank was still employing a "patched" data processing system, but it was working to develop a better system.

Chairman Burns said he was pleased to hear that the examiners had no serious criticisms at the present time. He then noted that in its comments on foreign currency operations the examination report said "In our opinion, the accounting records, the internal controls in effect, and the audit attention are adequate." He asked how the word "adequate" in that statement should be interpreted.

Mr. McWhirter replied that the word in that context could be taken to mean "entirely satisfactory;" given the present data processing system, the examiners had no suggestions to offer.

> The report of examination of the System Open Market Account, made by the Board's Division of Federal Reserve Bank Operations as at the close of business April 25, 1975, was accepted.

Mr. McWhirter left the meeting at this point.

> By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on July 15, 1975, were approved.

> The memorandum of discussion for the meeting of the Federal Open Market Committee on June 16-17, 1975, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the 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 15 through August 13, 1975, and a supplemental report covering the period August 14 through 18, 1975. Copies of these reports have been placed in the files of the Committee.

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

> Following the last meeting the dollar continued to rise against most major currencies on a combination of further favorable news, including the report of

another record U.S. trade surplus for June, and on the strength of its own upward momentum as speculative short positions in dollars and adverse leads and lags were unwound. Moreover, interest rate differentials continued to favor shifts into dollars--out of marks and Swiss francs in particular--and evidence so far confirms our impression at the time that a substantial volume of funds was pulled into the U.S. and Euro-dollar markets throughout July. By month end, the dollar had risen against the mark by a further 5 per cent, up 11 per cent from the May low and fully 13 per cent from the bottom reached last February.

By that time also, the Federal Reserve had taken advantage of the turnaround in dollar rates to liquidate fully the remaining $135 million worth of indebtedness in German marks. This completed an operation which dated back to last October. Over that 10-month period System intervention amounted to $1.7 billion, of which $1.3 billion was financed by swap drawings. In unwinding the debt the System had gross profits of $15 million, half of which was shared with the respective central banks. As discussed at the last meeting, we have since picked up a modest amount of mark balances for future contingencies.

Early in August renewed concern over inflation in the United States, particularly as reflected in the latest wholesale price index, gave pause to the market and set off some profit-taking following the previous sharp run-up in dollar rates. European central banks stepped in quickly to check the fall-back in rates and the dollar stabilized with no need for the Desk to intervene. Dollar rates currently are holding at about 1 to 1-1/2 per cent below the recent peaks.

In part the dollar's current buoyancy against continental European currencies reflects the weakness of the German mark, which is at the bottom of the EC snake. Even the German government is now pessimistic about the prospects for early economic recovery in Germany and additional stimulative measures are under discussion. The German Federal Bank cut its discount rate again last week, and money market rates are probably unsustainably low there, with call money at about 1 per cent right now. The German Federal Bank also has lifted its prohibition on the payment of interest on non-resident deposits. This makes little difference now but once the German economy begins to show signs of recovery and interest rates firm up, it could open the way for heavy inflows of funds and a bidding up of the mark rate once again.

At least for the time being, the dollar seems to be firmly based, and many traders believe that the fundamentals continue to favor a further rise at some stage. Market participants are quick to point out, however, that our relative price performance remains a major concern.

In reply to a question by Chairman Burns, Mr. Pardee indicated that the System--in addition to liquidating its remaining swap debt in German marks--had acquired $10 million in that currency for future contingencies.

Chairman Burns asked Mr. Pardee if he had the impression that the French, and perhaps also the Germans, were deliberately seeking a further depreciation of their currency.

Mr. Pardee said he thought the French and the Germans welcomed the appreciation of the dollar, but he did not believe they were deliberately encouraging a depreciation of their own currencies. President Giscard d'Estaing had stated that a suitable level for the French franc would be 4.6 francs per dollar; it was currently around 4.35 francs per dollar. It was his impression that the Germans would not intervene forcefully to stop the dollar from rising until the exchange rate got to 2.67 marks per dollar; the present level was about 2.56 marks per dollar. He thought the Europeans in general, including the Swiss, would welcome a further appreciation of the dollar. They seemed prepared to intervene quickly to resist a drop in dollar rates but not to offer much resistance to a rise in those rates.

In the latter connection, Mr. Pardee continued, the Europeans had arrangements for intervening if the dollar were to rise by 1 per cent or more on a given day. They had in fact intervened on that basis from time to time, but in relatively small amounts--$10 to $20 million at a time.

> By unanimous vote, the System open market transactions in foreign currencies during the period July 15 through August 18, 1975, were approved, ratified, and confirmed.

Chairman Burns asked if the Manager had any recommendations at this time with respect to foreign currency operations.

Mr. Holmes observed that he had no recommendations to make with respect to roll-overs of maturing swap drawings; all of the System's drawings of the past year had now been paid off and there were no maturities of the older drawings of Belgian and Swiss francs in the period ahead. He wanted to report, however, on the status of negotiations involving those drawings and to outline the steps he believed were necessary to get the drawings repaid.

With regard to the Belgian swap debt, Mr. Holmes indicated that on August 14 Messrs. Wallich, Pardee, and he had held what he hoped had been a constructive discussion with Mr. Yeo, the Under

Secretary of the Treasury for Monetary Affairs. Mr. Yeo agreed to set forth the Treasury's position on the matter in the near future. Unfortunately, repayment of the Belgian swap drawing was still being held up by disagreements on loss sharing. As the Committee members would recall, an effort had been made to reach an agreement with the Belgians on a 50-50 sharing of the losses arising from the appreciation of the franc due to floating. There was no disagreement as to the System's obligation to absorb the loss arising from the two devaluations of the dollar since the drawings were made, or to the Belgians' responsibility for the loss arising from the revaluation of the franc. However, the Belgians had insisted--and the System's lawyers tended to agree--that losses due to floating were not covered by the swap contract, and they had adamantly opposed any sharing of such losses. The Treasury had been equally forceful in insisting on a 50-50 sharing of losses.

Mr. Holmes noted that Mr. Wallich had now made a counterproposal to the Treasury under which the United States would absorb the bulk of the loss. If the Treasury's reaction was favorable, the System could proceed to negotiate with the Belgians. If the negotiations did not prove successful--and he was afraid the Belgians would remain firmly opposed to any sort of loss sharing--he would be prepared to recommend that the System absorb the full loss, which amounted to $14 million at current exchange rates.

Since the Treasury had asked the System not to acquire Belgian francs until the loss-sharing problem was resolved, Mr. Holmes continued, the System could find itself in direct conflict with the Treasury. A fundamental issue would be involved--namely, the right of the Federal Reserve to undertake independent action in the foreign exchange market--and that issue might have to be resolved at the highest level. In the interim, the Belgian authorities had agreed to go ahead and obtain the parliamentary approval necessary to implement the revaluation clause of the old swap contract, so that at least something was moving forward on the Belgian swap problem.

Mr. Holmes said the renegotiation of the Swiss franc debt would probably be less difficult, although there still was the more fundamental problem of how to acquire Swiss francs, given the strength of that currency. The Swiss had agreed earlier to share at least part of the loss due to movements in market rates, provided the System acquired Swiss francs at a rate of 3.1 per dollar or better. In a recent conversation President Leutwiler of the Swiss National Bank had agreed to reconsider this loss-sharing formula in view of the substantial further appreciation of the Swiss franc, which was now trading at about 2.66 or 2.67 francs to the dollar. He (Mr. Holmes) planned to have more detailed discussions with President Leutwiler during the forthcoming meetings of the World Bank and International Monetary Fund. He would probably recommend that the Committee approve whatever loss-sharing formula could be negotiated at that time. Whether or not the Swiss were prepared to accept a 50-50 formula was by no means certain, but in light of the 90-10 loss-sharing arrangement the System wanted to propose to the Belgians, he believed the Federal Reserve should be prepared to accept something less than a 50-50 proposal from the Swiss. In any case, President Leutwiler had assured him that the outcome of the negotiations with the Belgians would have no bearing on the Swiss position even if the System ended up taking all the market loss on the Belgian drawing.

Mr. Holmes said he hoped his outline of possible steps for settling the Belgian and Swiss franc debts would be satisfactory to the Committee. Once the loss-sharing arrangements were negotiated, he would plan to take advantage of every opportunity to acquire Belgian and Swiss francs in the market, from the partner central bank, or from other sources. Progress was certain to be slow, but he was sure the Committee wanted to get the operations started as soon as possible. He hoped there would be something constructive to report on these matters by the time of the next Committee meeting.

Chairman Burns said the Committee had reason to be grateful to Messrs. Wallich and Holmes for their efforts, and he hoped they would be able to resolve the problem with the Treasury. If they could not, he was confident that Secretary Simon and he could arrive at a quick understanding.

In reply to questions by Mr. Bucher, Mr. Holmes said the loss on the Belgian drawing stemming from two devaluations of the dollar, less that arising from the revaluation of the franc, had been $55 million. The System's responsibility for that loss was not in dispute; the disagreement related to the further loss of $14 million associated with the subsequent depreciation of the dollar against the Belgian franc in the exchange market.

Mr. Pardee observed that the $14 million loss was a current estimate based on prevailing exchange rates. At one time earlier this year the estimated loss had been around $50 million.

Mr. Maroni, Senior Economist, Division of International Finance, Board of Governors, entered the meeting.

Mr. Holmes referred to a memorandum from the Board's staff dated August 12, 1975, and entitled "Possible increase in swap line with Bank of Mexico," and to his related memorandum, dated August 19, 1975, in which he recommended that the present swap line be doubled to $360 million.[1/] He noted that Messrs. Wallich and Pardee had been active in working out the details of the proposed increase.

1/ Mr. Holmes' memorandum was entitled "Doubling of the swap arrangement with the Bank of Mexico and possible drawing in full by that Bank." Copies of both memoranda have been placed in the Committee's files.

Mr. Bucher said he was somewhat concerned by the suggestion in the staff memoranda that the Mexican authorities contemplated a 6-month drawing on the enlarged facility. To the best of his knowledge all swap arrangements in the past had provided for 3-month maturities on drawings.

Chairman Burns indicated that the matter was of some concern to him also.

Mr. Bucher commented that it might be desirable to retain the 3-month maturity on drawings. Since the Mexicans did not expect to be able to repay the drawing within that period, it could be understood that a 3-month extension would probably be granted. He wondered whether such a procedure would be acceptable to the Mexican authorities.

Mr. Pardee said he had discussed that question explicitly with the Mexicans, because a 6-month maturity on drawings would be inconsistent with all of the System's past practice. They were perfectly agreeable to a 3-month drawing which they could renew for another 3 months.

Mr. Pardee added that there had been a number of drawings by other central banks where repayment within 3 months had been more a hope than an expectation. In the present instance he thought the Mexican authorities were realistic in their view that repayment was unlikely in 3 months but would be feasible within 6 months.

In response to another question by Mr. Bucher, Mr. Pardee said he would recommend a 3-month maturity for the drawing with the understanding that the Committee would not object to a renewal for a further period of 3 months.

Mr. Coldwell asked if the proposed size of the Mexican swap line was justified in relation to the size of the swap line facilities with other countries.

Mr. Wallich commented that the proposed size of the line should be viewed against the background of some special characteristics of the System's swap line with the Bank of Mexico. On the one hand, the degree of potential reciprocity was probably less than in the swap lines with European central banks. On the other hand, Mexico was on the verge of moving out of the class of less developed countries. If all LDC's were classified according to the threefold division of very poor countries, OPEC countries, and better-situated countries, Mexico would rank well up in the last group. The proposed increase in the swap line would amount to recognition of that fact. In his opinion the swap line would not be unduly large in relation to Mexico's trade, capital flows, reserves, IMF quota, and other criteria. The size of swap lines varied greatly in relation to such criteria and one could not establish any rigid standards.

Mr. Coldwell observed that, if his recollection was correct, an exception to the usual standards for swap lines had been made when the facility with the Bank of Mexico had been put in place. In any event, he wondered if the proposed increase would open the doors to requests from other countries in Latin America for swap lines with the System.

Mr. Pardee said he did not think any exception had been made for Mexico; that country had fully met the criteria for inclusion of its central bank in the System's swap network--in light of the convertibility of its currency, its substantial foreign trade, and its general financial standing--when the swap agreement had been made in 1967, and it still did so. On the basis of the same criteria, it had been decided in 1967 not to make swap arrangements with the central banks of Venezuela and Argentina. Informal inquires were continually being made by other central banks regarding possible admission to the System's swap network, but nothing had crystallized to the point where it should be brought to the Committee's attention.

Mr. Volcker said he shared some of the reservations about the proposed increase that other members had indicated. To his mind the Mexican swap line did not fall completely within the normal pattern in that it was more likely than other System swap arrangements to be a one-way facility. He was also a bit concerned about the precedent-setting character of the Mexican facility for other Latin American countries, a character that would become more prominent if the size of the line was increased. The proposed size seemed to him to be a little on the high side, particularly if account also was taken of the Treasury's swap agreement of $200 million with Mexico. On the question of the maturity of drawings, he favored 3-month renewable terms, as provided in the System's other swap contracts. Another question was whether the Bank of Mexico would draw immediately on the enlarged swap line in advance of need. He understood that during the most recent conversations the Mexican authorities had indicated that they would not necessarily draw immediately. That position, he thought, would be more in keeping with the general character of the swap arrangements.

Mr. Volcker remarked that his reservations were not strong enough to suggest that the Committee should not go ahead with the proposed increase, given the extent to which negotiations had already proceeded as well as other circumstances. Mexico was a close neighbor with which the United States had many developing trade and other relationships. However, this was an area in which the Committee should be particularly wary of creating any unnecessary precedents.

Chairman Burns said he might note that he had talked with the Secretary of State about the proposed swap line increase. The Secretary had advised that the Department of State had no special interest in the matter and that the Federal Reserve should make its decision on the basis of banking considerations.

Mr. Coldwell said he had a concern of a more fundamental nature than those he had mentioned earlier. It was his impression that the contemplated drawing on the enlarged swap line would be intended to finance a cash need tied largely to the turnover of the Mexican Presidency. Mexico might also have a longer-run need insofar as its economic policies were resulting in a deterioration of its balance of payments. In effect, the System might be helping to finance a politically related need for 6 months and also, perhaps, a longer-run need. He would wonder about the System's policy posture if it agreed to increase the Mexican swap line under those circumstances but refused financial assistance to New York City.

Chairman Burns expressed the view that the two matters were not related. He went on to note that the System had substantially increased its swap lines with the central banks of a number of other countries in recent years on the basis of economic and financial considerations. One could argue, however, that those actions had political implications; since any swap line increase tended to help the government in power, political implications were inescapable.

Mr. Wallich said he thought it was necessary to view the proposed increase in perspective. First, because Mexico had been borrowing as much as $2 billion in world markets for periods longer than 6 months, the proposed drawing was not a major matter. Second, as Mr. Coldwell had indicated, Mexico had a special need for short-run financing. However, that need was one which recurred with the nation's election cycle and there was nothing fundamentally abnormal about it. Third, the Mexicans were putting together a package of measures designed to deal with the balance of payments situation, and the increased swap facility would fit into that package as an additional backstop.

In his view, Mr. Wallich continued, there was no way of comparing a loan to New York City with a swap drawing by another country; swap drawings were a traditional financing device, offering temporary balance of payments accommodation. A loan to New York City would represent a departure from past practice and would open the door to many other demands for System credit. In that connection he would not be inclined to favor System swap agreements with less developed countries in general, precisely because they might come close to involving the Federal Reserve in situations resembling that of New York City.

Mr. Holland said he was prepared to begin extending the System's swap network gradually to the more prosperous earners among the developing countries--those countries that were becoming significant factors in world financial markets because of oil or other export earnings. He saw Mexico as a logical first among such nations and it would probably not be the last. He felt, however, that the majority of LDC's would not fall into the group, as he defined it.

In his judgment, Mr. Holland continued, it was important for the System to deal with the Mexican swap arrangement--and with any others that might come along, he hoped gradually--in ways that would serve to educate the new swap partners about the purposes of the network. Indeed, he regarded that educational process as a key part of the whole swap line relationship. In the negotiations with the Mexicans he would stress the traditionally short-run nature of swap drawings--including the policy of 3-month maturities. He would be polite but unequivocal on the point.

Mr. Holland indicated that he was troubled by the suggestion that the Bank of Mexico might draw immediately on the swap facility in order to augment its reserves in the expectation of outflows. On that point also, he thought some polite but unequivocal indications would need to be given to the effect that drawings were expected to be made only to replace actual reserve losses. That had been the usual practice. It could not be maintained that swap drawings had never been used to buttress reserve figures, but that was not the intended purpose of the swap network. He would impress upon the Mexican authorities the System's expectation that they would adhere to the typical standards of swap line usage.

Mr. Wallich observed that the Mexican authorities had begun conversations with Mr. Hayes on this matter in January of this year. Thus, they had anticipated the present situation well in advance of any actual need to borrow.

Mr. Mitchell said he supported the proposed increase in the Mexican swap line. Ever since he had become a member of the Committee he had urged that the swap network be extended to include Latin American countries. The Committee had been reluctant to do so, for reasons related to the issue of financial responsibility. But standards of responsibility were subjective as well as objective, and in light of the experience of recent years he thought many Latin American countries did not differ much from European countries. Moreover, the United States was becoming more dependent on such countries as Mexico and Venezuela.

Mr. Mitchell went on to say that the memorandum in which Mr. Holmes recommended a doubling of the Mexican swap line was distinguished by its candor, both with respect to the duration of the contemplated drawing and the reasons for it. In his view, however, the memorandum was deficient in two respects. First, it did not spell out the standards that should be applied in deciding on the appropriate size of a swap line. For example, he had little basis for judging whether a $360 million facility with the Bank of Mexico was in line with a $2 billion facility with the Bank of Canada. Applicable criteria could probably be found in the records of the Committee, but the memorandum did not apply them to the recommended increase. Second, and more important in his opinion, the memorandum in its present form could be misinterpreted as implying that the proposed increase was motivated primarily by political considerations. While that was not the case, he was concerned about the possible consequences of releasing the memorandum in its present form at some future date.

In subsequent discussion it was noted that the longer Board staff paper, which was referred to in Mr. Holmes' memorandum, commented at length on the economic and financial reasons for the swap line increase, and would be included along with Mr. Holmes' memorandum in the Committee's files.

Mr. Volcker said he would find it easier to approve the proposed increase if the Mexicans were to announce the enlargement of the swap facility in connection with a balance of payments program or an internal program of some sort. There was no doubt in his mind that the United States should lend support to Mexico if its currency was threatened and the Mexicans were prepared to take corrective steps. Mexico was deserving of such support in view of its long period of stability and its increasingly open relationships.

Mr. Wallich indicated that the Mexicans had been struggling with inflation for some time. Like other countries, they had been affected by the world recession recently, and consequently had introduced some expansionary economic policies. Those policies were having an adverse impact on their balance of payments and they were now moving to adopt a set of corrective measures. Final decisions had not yet been made on the specific measures, but the package was expected to be announced by September 1.

Mr. Pardee said he understood that the measures would include curbs on Government spending.

Chairman Burns said he thought the Committee was ready to vote on the recommended increase. He would draw to the Committee's attention the concluding sentence in Mr. Holmes' memorandum, which read as follows: "Since the timing and other technicalities still have to be discussed with the Mexicans over the next few days, I recommend that final action be made subject to review and approval by the Chairman." He proposed that the Committee vote on the proposal on that basis.

By unanimous vote, the Committee authorized an increase of $180 million, to $360 million, in the Federal Reserve swap arrangement with the Bank of Mexico, and the conforming amendment to paragraph 2 of the authorization for System foreign currency operations, subject to the understanding that the action would become effective upon approval by Chairman Burns after a final review of technical details.

Secretary's note: Chairman Burns approved the increase on August 29, 1975.

Mr. Maroni left the meeting at this point.

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

Mr. Gramley made the following statement:

Information becoming available over the past month has confirmed the view that the economic recovery is now under way. The rate of inventory liquidation slowed materially in June, and in July industrial production registered its second increase of 0.5 per cent. Labor markets also strengthened further last month, but the household sample survey probably overstates the degree of improvement. Employment in this series rose by 600,000, and the unemployment rate fell from 8.6 to 8.4 per cent. Nonetheless, there has been a strengthening over the past couple of months in the payroll series, too. In manufacturing, for example, new hires have risen further, layoffs have continued to decline, and the amount of overtime work has increased.

Most of the gain in industrial activity so far has been in nondurable goods lines. However, new orders for durable goods increased somewhat further in June, and the latest reports of purchasing agents suggest an additional rise in July.

Retail sales, meanwhile, marked up another good gain last month, and revised data show higher levels of sales in May and June than earlier indicated. Housing, on the other hand, has shown somewhat less improvement than we had expected, though starts were up 14 per cent in July--reflecting a jump in multifamily units--and permits rose 6 per cent. The staff believes, however, that a case can now be made for a rebound in real GNP growth for several quarters to the 7 to 8 per cent range--that is, the range that has been typical of the early phase of postwar recoveries.

The principal thrust is expected to come from the inventory sector. A month ago we had been estimating an annual rate of inventory liquidation of about $20 billion during the second quarter. Data now available suggest that the pace of liquidation was nearer to $30 billion and that our estimates of final sales for the second quarter were too low. Imports fell more than had been expected, while exports fell less; the merchandise trade surplus therefore showed an unexpected, and large, increase. We also underestimated the rise in consumer spending, particularly for durables. It looks to us as though revised GNP estimates for the second quarter--to be published by BEA later this week--will show a rise in real GNP, perhaps on the order of 1 or 2 per cent, annual rate. More importantly, these second-quarter data will confirm a marked imbalance between rates of production and final sales of the sort that, in previous postwar cycles, has been associated with a brisk rebound in industrial output and real GNP.

On the basis of these developments, we have increased significantly our projection of real GNP growth in this and the next two quarters--to an annual rate of around 7-1/4 per cent. This would mean more progress in reducing the unemployment rate; in our projection, the rate falls to around 7-1/2 per cent by the end of next year. We have not, however, been led to change our judgment that there are fundamental unresolved problems that will dampen the extent of economic recovery. For example, the housing recovery looks like it will be moderate and a little weaker than we thought a month ago. And unfortunately, the most formidable obstacle to a good economic recovery--the problem of continuing inflation--appears to be in process of worsening.

Recent announced price increases for aluminum, steel, and autos have been disconcerting, but not entirely unexpected. However, the outlook for food prices has deteriorated more over the past month than we had expected, as it has become evident that Soviet grain purchases will be large, that the domestic corn crop will be less abundant than had been estimated, that frost has damaged next year's Brazilian coffee crop, and that dry weather in Europe may have reduced supplies of sugar beets. At wholesale, prices of farm products and processed foods have been rising strongly; for major grains, any hope that prices will go back down again would not seem very realistic. Our estimates of retail food price increases have therefore been raised considerably--to an annual rate of around 7 per cent between now and the end of 1976. Over all, we expect the bleaker outlook for farm and food prices that has developed over the past month to add about .6 per cent to the projected level of the GNP deflator by the end of next year.

Part of the rise in food prices at retail may be held off until early 1976 by weakening retail beef prices this fall. But the effects of decontrol of oil prices at the end of this month--which now seems almost inevitable--are likely to hit sooner.

Our current projection assumes that the cost effects of decontrol will be partly offset by the removal of the $2 import fee. We continue to assume, for lack of better information, only a $1 increase per barrel in OPEC prices for crude oil. A straight dollar-for-dollar pass-through of higher crude oil prices resulting from decontrol--and the partial effect of the reduced import fee--would imply an average rise of around 7 per cent in wholesale prices of refined products, about a 2-1/2 cent rise in retail gasoline prices, and an increase of 0.4 per cent in the level of the GNP deflator. A $1 OPEC price increase would add another .2 per cent to the deflator.

We assume that the fiscal effects of rising oil prices--that is, the effects on consumer disposable income--will be offset by passage of something like the Long bill, which taxes away the additional profits from rising crude oil prices--after allowing a plow-back credit for increased investment--and redistributes them to individuals. But such a measure--though helpful in maintaining consumer purchasing power--would not take care of the monetary effects of rising prices. The combined influence of new assumptions about higher food and fuel prices would raise the general price level by about 1 per cent, and most of this would occur by the end of the first quarter of 1976. As a result, the projected annual rate of increase in the fixed-weight deflator for gross private product in this and the next two quarters has been raised to 7-1/2 per cent.

Price increases of these dimensions, coming at a time of a rebound of real GNP growth to the 7 to 8 per cent range, would, we believe, put inordinate strains on financial markets if growth rates of the monetary aggregates were held to the midpoints of current target ranges. Our GNP projection assumes, therefore, that growth rates of the major aggregates would be permitted to drift toward the upper end of the current ranges, so that M_1 would be growing at an annual rate of around 7-1/4 per cent beginning next quarter. Even so, there is apt to be a sizable further rise in market interest rates, and we have also assumed some relaxation in Q ceilings early next year to keep disintermediation down to tolerable proportions.

Even with these monetary policy assumptions, the projected average rate of expansion in nominal GNP over the next several quarters--which is around 15 per cent--is unlikely to continue for very long if the narrowly defined money stock grows at around 7-1/4 per cent. Increases in the velocity of M_1 at annual rates of 7 per cent or more for a sustained period seem highly improbable.

A partial resolution of the difficulty may come from a slowdown in the rate of inflation, as the effects of rising food and oil prices wear away. We are projecting the increase in the general price level to subside to around a 5 to 5-1/2 per cent annual rate by the latter half of 1976. But real GNP growth is also expected to taper off--to a 4-1/2 to 5 per cent annual rate--by late next year. Some of this slowdown would come from normal cyclical forces--in particular, a diminished stimulus from the inventory sector as rates of accumulation reach a normal relation to GNP. A significant part of the slowdown would be expected to come, however, from restraints developing in financial markets.

> We are projecting commercial paper rates to rise above 11 per cent by the latter half of next year; savings flows to the specialized mortgage lending institutions to decline to the 5 to 6 per cent range; housing starts to level out early next year and then turn down (after only a moderate recovery); a weak stock market; and a personal saving rate remaining in a range of 7-1/2 to 8 per cent.
>
> This is an unsettling projection. I am well aware that it is a projection, and only that; all sorts of things could happen that the staff has not foreseen--things that could alter the economic and financial climate in major ways. For example, we have not factored in any effects of a failure to find a resolution to the problems of New York City, or any impact of natural gas shortages on industrial production. At this juncture, however, we see no easy way out of the dilemma posed by aggravation of an underlying inflationary problem at a time when the economy has barely begun to recover from the deepest recession of the postwar period.

Chairman Burns commented that it would be desirable if Committee members' remarks on the economic situation and outlook were brief and were concentrated on points of significant difference from the staff analysis and on any supplementary observations.

Mr. Leonard observed that while there were differences of opinion around the table concerning the appropriate monetary objectives and the precise role of interest rates, there nevertheless was a common enemy: a group of economists and politicians who might be characterized as inflationists, whose recommendations for monetary policy went far beyond what might be characterized as moderate. In the interest of promoting a sustainable recovery, it was important to discredit the analysis of the inflationists, which had a certain superficial appeal. The recommendation to stimulate the economy aggressively until signs of new inflationary pressures began to appear was based, in his opinion, on a misreading of the events of the last several years. In the past the gains of a highly stimulative policy in terms of reduced unemployment had been temporary whereas the inflationary effects had been more lasting, and pursuit of such a policy at this time would quickly lead to serious trouble.

Continuing, Mr. Leonard said the rationale for a highly stimulative policy rested in part on the large amount of unused resources available in the economy. However, there was a difference between an engineering concept of capacity and an economic concept. He would suggest that the special factors--such as the poor crops and the energy shortages--that had reduced output in 1973-74 also had reduced capacity. Moreover, it was unlikely that additions to the capital stock during the recent period of weakness in business fixed investment had been significant. In his opinion the limits of economic capacity would be reached much sooner than the inflationists believed. The key to sustainable recovery and growth was to be found in the pursuit of moderate policies, so as to avoid the need for later restriction with attendant harmful effects on output and employment.

Mr. Coldwell asked whether there were items other than foods and energy--which Mr. Gramley had emphasized--that were likely to contribute to a rise in the rate of increase in the price level.

Mr. Gramley observed that he had emphasized foods and energy because they were responsible for the change in the staff's projection of prices from a month ago. He was not sure that the announced increases in prices of aluminum, steel, and autos--which were small--were inconsistent with the outlook as seen by the staff a month ago, which was for some further progress in reducing the underlying rate of inflation. The key question, which could not be answered now, was whether prices for those commodities would be increased further during the coming year of recovery in activity.

Mr. MacLaury observed that the discrepancy in behavior between the household and establishment data for employment was disturbing, because of the resulting uncertainty in interpreting the employment situation itself and in analyzing cost and price developments. He asked whether the staff believed that the two series would come back into line and whether it believed that one was a more reliable measure than the other.

Mr. Gramley commented that the discrepancy, while still large, was reduced somewhat by adjustment of the July establishment data for the effects of strikes. After adjustment, nonfarm payroll employment rose 185,000 in July--instead of about 90,000, as reported--compared with an increase of about 490,000 for the nonagricultural component of the household series. Experience suggested that the establishment series was the more reliable, and he expected that over the near term the household series would show less increase, as a counterpart to the seasonal problems of recent months. The unemployment rate in particular was likely to show less improvement than suggested by the July figures, and he would not be surprised if the rate rose in August.

Mr. MacLaury noted that for the fourth quarter of this year the staff projection of the annual rate of increase in the fixed-weighted price index for gross private product had been raised by 2 percentage points, and he asked whether so large a change could be accounted for by foods and energy alone.

Mr. Gramley replied that the changed outlook for foods and energy had directly raised the projected increase in the deflator by a little more than one percentage point over the whole period to the fourth quarter of 1976, the last quarter of the projection period. However, the increases in those commodities were concentrated in the fourth quarter of this year and the first quarter of next year, causing the annual rates of increase in those quarters to be raised by considerably more than one percentage point.

Mr. MacLaury then observed that in making its GNP projection, the staff had departed from customary practice by assuming a rate of growth in M_1 that was higher than the rate the Committee had agreed upon at its last meeting. While he had been advocating a rate of growth in M_1 near the higher end of the 5 to 7-1/2 per cent range, and still thought that was appropriate, he did not understand why the staff had assumed the higher rate when the outlook now was for a faster rate of increase in prices and for a more vigorous recovery in activity. From a methodological point of view, he wondered what guidelines the staff had followed in deciding to change the M_1 assumption.

In response, Mr. Partee commented that in developing the projection for this meeting the staff had found that, in the absence of a change in the monetary assumption, the exogenous increases in prices of foods and energy would result in a quite different configuration of economic developments--including strains in financial markets, pressures in the housing industry, and a significant weakening in the pace of expansion by the second half of 1976. The staff had concluded that to present such a pattern in the fully elaborated projection would not serve the interests of the Committee. Accordingly, the staff had decided to raise the assumed rate of monetary growth within the Committee's 5 to 7-1/2 per cent longer-run range for M_1. The staff did have an alternative projection based on the 6-1/4 per cent M_1 growth rate that had been assumed previously. It indicated a level of real GNP in the fourth quarter of 1976 that was about 1-1/2 per cent lower than in the green book[1/] projection and an unemployment rate that was higher by several tenths of a per cent.

Chairman Burns remarked that he believed it would have been better had the staff continued the 6-1/4 per cent assumption for monetary growth and pointed out all its implications.

Mr. Mayo remarked that he supported the staff decision to raise the assumed rate of monetary growth for purposes of the projection. In his view, the staff had a responsibility to choose a growth rate, within the Committee's longer-run range, that would yield reasonable results.

Concerning the projections in the green book, Mr. Mayo said the course of prices looked more realistic to him now than it had a month ago. However, he was skeptical that there had

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

been as much improvement in the unemployment situation over the latest 2 months as was indicated by the household series, and he thought that the staff had gone too far in reducing the unemployment rate throughout the projection period by about 1/2 percentage point.

Mr. Gramley commented that there were two parts to the reduction in the projected rate of unemployment. First, the level in the current quarter now appeared to be lower than projected a month ago, even though the staff thought the recent figures contained a fictitious element and, therefore, had projected a rise in August that would hold in September. Second, the rate of growth in real GNP in this and the next two quarters was now considerably faster than in the projection of a month ago.

Mr. Kimbrel, noting Mr. Gramley's remarks concerning prospective disintermediation and weakening in the housing sector, asked what the effects of a change in Regulation Q ceilings might be in the light of the increase in average yields of mortgages in the portfolios of the nonbank thrift institutions over recent years and the lengthening of those institutions' liabilities.

In reply, Mr. Gramley said it was difficult to assess how much higher rates the nonbank thrift institutions could pay. The Board's staff was in the process of obtaining data on individual savings and loan associations from the Federal Home Loan Bank Board that would help to answer that question. From the aggregate data now available, he would judge that an increase of as much as 25 basis points in the average cost of funds would cause real difficulties for many S&L's. The change in Regulation Q ceilings that the staff had assumed--an increase of 50 basis points on the longer-term maturities--would not raise the average cost of funds that much, since it would provoke only a minor switch from passbook accounts to certificates.

Continuing, Mr. Gramley observed that because of the change in the structure of their liabilities over recent years, the S&L's were in a better position now to resist the effects of rising market interest rates. At the same time, however, the public had become more sensitive to rising market rates. The industry was concerned--rightly, he believed--that a substantial part of the large increase that had occurred in the passbook component of deposits was hot money that would move out as market interest rates rose. In addition, the public now had additional attractive alternatives to move funds into. For example, the money market mutual funds had developed during the past period of high interest rates, and they were likely to expand considerably as interest rates rose in this cyclical upswing.

Mr. Jackson remarked that the big swings in new housing activity had resulted from shifts in the willingness of the savings and loan associations to make forward commitments, stemming from changes in their expectations. At present, the relationship between their forward-commitment position and internally generated cash flow was much more sound than at this stage in earlier swings in new housing activity, and for that reason the cutback in activity might not be so sharp.

Mr. Gramley remarked that the staff's projection of the downward drift in residential construction was fairly mild. Housing starts were projected to reach a peak of 1.5 million in the first quarter of 1976 and to drop off to 1.4 million in the fourth quarter of the year.

Mr. Bucher asked about the basis for the staff projection of a strong expansion in business fixed investment throughout 1976, in view of the high projected levels of interest rates and of various environmental problems.

Mr. Gramley replied that the projection reflected a normal acceleration effect, as business fixed investment responded to strong expansion in consumer spending over an extended period and to a shift in inventories from liquidation at a rapid rate to accumulation at a pace more or less normal for a period of recovery.

In real terms, fixed investment was projected to decline further in the current quarter, although at a much slower pace than earlier, and to turn up in the fourth quarter of this year; in the second half of next year, expansion was projected at an annual rate of about 15 per cent. He believed that such behavior was a reasonable expectation. However, it was possible that a very sharp rise in interest rates would abort the expansion in investment outlays. That was one of the reasons for raising the assumed rate of growth in M_1 from 6-1/4 to 7-1/4 per cent.

Mr. Eastburn commented that he was concerned by the distinction that had been made between exogenous and endogenous price movements and, specifically, by the notion that the increases in prices of foods and fuels were exogenous and had to be accommodated. He had difficulty in distinguishing between the effects of those increases and the increases in steel, aluminum, and autos, and he felt that an accommodative posture too easily could lead to acceptance of inflation.

Mr. Gramley commented that significant changes in the rate of inflation because of the sorts of influence that were raising prices of foods and energy posed a dilemma for monetary policy. In such circumstances, monetary policy could not affect the rate of inflation in the short run. Given the demand and supply conditions for those commodities, an adjustment in relative prices had to take place, and because of the downward inflexibility of most prices, it was just about impossible to get the adjustment in relative prices without a rise in the general level of prices. Thus, if policy did not accommodate the price increases for foods and energy by permitting a higher rate of monetary expansion, the rate of growth in real GNP would be reduced.

Chairman Burns remarked that the problem was serious. Price increases were always occurring because of factors that might be classified as exogenous, and if policy always accommodated such increases, it would be validating a never-ending inflationary trend.

Mr. Volcker noted that the staff analysis suggested that in the short run the recovery would be vigorous but that it would be heavily dependent on a large shift in inventory accumulation. The analysis also suggested that the strength of further recovery in 1976 and beyond was in doubt. He asked how confident the staff felt about its projections for the next few quarters.

In reply, Mr. Gramley observed that the uncertainties at present were greater than usual for this stage of the business cycle. Reflecting those uncertainties, the range of projections was unusually wide; he had heard of responsible judgmental forecasters projecting annual rates of growth in real GNP in the third and fourth quarters of this year ranging from 5 to 14 per cent.

Mr. Volcker asked whether there was much chance that the rate would be less than 5 per cent.

In his opinion, Mr. Gramley said, the chances were quite good that the rate would not be less than 5 per cent. However, the greatest uncertainty in his mind--apart from the possible effects of such special events as a default by New York City and a shortage of natural gas next winter--was whether the strength in consumer markets would be sustained. The staff's judgmental projection was much more optimisitc than the econometric model, which gave more weight to the deterioration in consumers' financial asset positions that had resulted from the failure of stock prices to rise as much as the general level of prices and from the effects of inflation on the purchasing power of savings deposits and the like.

Mr. Partee added that no one could forecast changes in inventories with precision. The staff felt confident that inventories would shift from a high rate of liquidation to a lower rate and then to accumulation, but no one could be sure exactly when the shifts would occur or how large they would be. If the expected sharp reduction in the rate of liquidation should be delayed, vigorous recovery also would be delayed; or if the shift was already under way and proved to be greater than projected, the early stages of recovery also would be more vigorous.

Chairman Burns remarked that precise forecasting of inventories would require precise forecasting of the monumental errors in the inventory statistics.

Mr. Wallich said he would like to separate the real from the financial elements in the outlook and to distinguish his own view of the most likely course of events from that presented by the staff. His impression--which was influenced by the forecasts of others as well as by his own analysis--was that elements of strength in the economy had been accumulating and that a fairly vigorous boom would develop. The expansive influence of the shift in inventories would diminish, but then stimulus would come from business fixed investment and from other sectors. In the staff projection, the recovery was constrained by financial factors growing out of the assumed rate of monetary expansion. He believed, however, that in the absence of those financial constraints, the boom would be quite vigorous.

Continuing, Mr. Wallich observed that price behavior in the staff projection was relatively favorable, in part because of the financial constraints. It seemed to him, however, that the staff had not allowed for the prospect that even a temporary increase in the rate of inflation would be translated quickly into a faster rate of increase in wage rates and then into a generalized cost-push. Once the rate of inflation accelerated, it was difficult to slow it down again.

Altogether, Mr. Wallich remarked, a fairly strong economic situation appeared to be in the making. In the circumstances, he believed that the Committee would probably yield a little and that the rate of growth in M_1 would overshoot the Committee's target for a while. In any case, M_1 might not be the best guide to policy. Consequently, the staff projection of considerable strength early in the projection period and then rapidly diminishing strength did not seem realistic to him.

Chairman Burns commented that he agreed with Mr. Wallich's views on the economic outlook. The economy was in the process of developing momentum. Business fixed investment was likely to become a major factor providing an upward thrust next year, so that the tapering off of growth in real GNP would not be as great as suggested by the staff projection. In the circumstances, he would expect the rate of inflation to accelerate. Business cycle history certainly suggested such a pattern of developments, although the teachings of the past might or might not apply to the coming year.

Mr. Balles said he shared the view that the rate of inflation was likely to increase. Companies in every industry represented among the directors of the San Francisco Bank were reported to be thinking about raising prices at the earliest opportunity. In the view of the directors, the recently announced price increases for steel, aluminum, and autos were only the beginning of a rash of increases. With that prospect in mind, he believed that it would have served a useful purpose for the staff to have continued the assumption of a 6-1/4 per cent rate of growth in M_1 for purposes of the projection, so that Committee members would have been given an idea of the full implications of that rate of monetary growth. He would like to know, in particular, how much lower the projected rate of inflation would be with the 6-1/4 per cent assumption.

Mr. Gramley commented that in the last two quarters of 1976 the annual rate of increase in the fixed-weighted price index for gross private product was .2 percentage points lower with the assumption of M_1 growth at a rate of 6-1/4 per cent rather than 7-1/4 per cent.

Continuing, Mr. Balles remarked that in his opinion the trade-off between the rate of increase in prices and improvement in the employment situation posed the real dilemma that Committee members ought to focus on. He was uncertain about how to judge price prospects at this time. However, he was concerned that if policy accommodated actual or prospective increases in prices too readily, it would help to place an upward ratchet under the price level.

Mr. Winn--noting that the staff projection of real GNP took no account of energy limitations--observed that businessmen in the Cleveland District were concerned that shortages next winter, particularly of natural gas, would force some plants to shut down for as long as 6 months. In anticipation that such cutbacks in production would create bottlenecks, many plants now were being operated around the clock in order to build up inventories. Altogether, the prospective energy shortage was a seriously disturbing influence on the shape of the recovery.

Mr. Gramley noted that the staff had not tried to incorporate in its projection any curtailments in production arising from energy shortages. However, the staff had assumed a 10 per cent increase in natural gas prices. Such an increase would tend to raise the output of natural gas, but it would not eliminate the problem.

With respect to price rises, Mr. Winn commented that the recent increases in interest rates needed to be added to the list. He was particularly concerned that the current relationship between interest rates and profit margins--which he thought might be unprecedented for this stage of the business cycle--would have an adverse effect on business fixed investment.

Chairman Burns remarked that as far as he knew this recovery was starting with a level of interest rates that had no precedent in business cycle history. However, inflationary expectations also were strong. He questioned whether a businessman would be much concerned about paying an interest rate even as high as 10 per cent if he expected prices to rise at a rate of 7 or 8 or 9 per cent.

Mr. Gramley commented that if the staff projection was internally consistent and if the price projections were correct, profits would increase substantially over the next year; during the recovery in output from the third quarter of this year to the fourth quarter of 1976, corporate profits plus IVA were projected to increase by 50 per cent.

Mr. Holland observed that in the past few months his view of the economic outlook had differed in some ways from that of the staff. However, both his view and that of the staff had changed somewhat, and he found the latest staff projections for the next few quarters--into the early part of next year--to be more in accord with his sense of what was developing. Concerning the rest of 1976, there were arguments for and against both an investment boom and a stronger housing market than projected by the staff. In both cases, many of the influences were importantly conditioned by financial variables over which the System had some control, because they were closely related to market interest rates and Regulation Q ceilings. In his opinion, moreover, changes in the financial variables were likely to affect developments with a shorter lag than that involved in the usual relationship between M_1 and GNP. Therefore, the System had a little more time in which to affect growth in 1976 moderately in either direction. The Committee could await further developments before making the kinds of judgments that would shade the financial variables in one direction or the other; it did not need to make such decisions today.

Concerning the staff assumption for the rate of monetary growth, Mr. Holland remarked that it would always be useful to maintain continuity from one meeting to the next; a projection based on the Committee's existing target for M_1 would enable Committee members to evaluate changes in the outlook arising from other sources. At the same time, however, it would be helpful to present an alternative projection that would suggest the consequences of a change in the Committee's monetary target. In the present case, he believed that it would be a mistake not to adjust the monetary target in order to validate some part of the effects of the exogenous increase in prices, because it would be unrealistic to expect compensating downward adjustments in other prices. It would also be a mistake to validate all of the price rise--which he believed would be greater than suggested by the staff--because the Committee had a responsibility to resist the secondary effects of the increases in foods and energy.

Chairman Burns commented that he agreed with Mr. Holland's last point in principle. In practice, however, the Committee might find itself attempting to engage in fine tuning, for which there was insufficient knowledge. The short-run influence of changes in monetary growth on economic activity and prices was so loose that the Committee might find itself manipulating numbers rather than attending to real developments in the economy. While recognizing that there was a trade-off in the short run between inflation and unemployment, he would prefer to hold to the monetary growth path that the Committee had adopted. Should there be a very large exogenous movement in prices, however, he would not regard the accommodation of some part of it as fine tuning.

Mr. Baughman observed that in his District uncertainty was having an adverse effect on exploratory activities and investment decisions in the petroleum industry. Moreover, producers there, like the Arabs, were adopting the view that whatever oil was not taken out of the ground today could be taken out tomorrow, and it might be just as well to take it out later. Consequently, movement in the direction of decontrol of oil prices, which might well be regarded as permanent, was likely to have a considerable effect on the industry. In the cattle-feeding industry, production had improved and was now up to about 50 per cent of capacity. Cattle coming out of the feeding yards at present were returning a modest profit to the operators. He would expect some further increase in production in that sector, although it could be choked off by the rise in grain prices.

Bankers in his District, Mr. Baughman continued, were still quite concerned about the nature of their loan portfolios. They emphasized that they were not booking many new loans and that those they did book were reviewed very critically. No aggressiveness on the part of bankers seemed to be developing, and he thought the situation was much like the one he had observed a few years ago from his position at the Chicago Bank, when country bankers in that Bank's District were content to sell funds rather than to extend themselves to cultivate the credit potentials of the local communities.

Mr. Baughman remarked that, like some speakers who had preceded him, he wondered about the effects of the current high level of interest rates--to say nothing of a further increase in rates--on the economic expansion, especially in view of the relatively low rates of resource use. His staff at the Dallas Bank was inclined to believe that in the present environment, even modest increases in rates from current levels would impose greater restraint on the economic expansion than might be suggested by historical relationships.

Mr. Baughman then said he recalled that about 2 months ago the staff had suggested that stock prices were likely to rise over the balance of 1975. The staff report this morning, however, seemed to be bearish about the outlook for stock prices, and he wondered whether the shift had been caused by the strengthening in inflationary expectations.

Mr. Partee commented that a few months ago, in response to a question, he had reported the econometric model's projection of a substantial rise in stock prices over the period to the fourth quarter of 1976. The staff had not made such a projection judgmentally. In his opinion, the stock market now was being affected by a worsening of inflationary expectations and by anticipation of higher interest rates. Moreover, the gloom arising from the financial problems of New York City pervaded financial markets.

Chairman Burns remarked that--while he had commented on occasion about the size of revisions in staff projections and while he often did not agree with the projections--he wished to make clear how much he admired the projectionists' work. The staff was forthright and thorough in its effort to take account of new developments and revise its projections, and it maintained a record of successive estimates for each quarter. Precisely because of good scholarship, the staff always indicated the changes in judgments about the outlook and the reasons for them. Therefore, Committee members had to listen to the staff, but they also had to take the projections with a grain of salt.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period July 15, 1975, through August 13, 1975, and a supplemental report covering the period August 14 through 18, 1975. Copies of both reports have been placed in the files of the Committee.

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

> System open market operations have maintained essentially steady bank reserve and money market conditions since the last meeting of the Committee. Immediately after that meeting, it appeared that monetary growth over July and August might exceed the Committee's tolerance ranges. As a result, we held back in providing nonborrowed reserves with a view to letting the Federal funds rate rise from around 6 per cent to the vicinity of 6-1/8 to 6-1/4 per cent. Thereafter, we pursued a steady course, as the aggregates fell back within their ranges and the credit markets were troubled by the Treasury's cash needs, by New York City's problems, and by fears that the price outlook was deteriorating. Over the period the Federal funds rate averaged close to 6-1/8 per cent.
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> Operationally, we had to drain a substantial volume of reserves from the banks, in part because of the $1.2 billion decline in average Treasury balances at the Federal Reserve to an overdraft position in the 4 weeks ended last Wednesday. The Desk was able to accomplish this task with very limited

market intervention during the period. In the market we did sell Treasury bills on three occasions, and we made both matched sale-purchase transactions and repurchase agreements on four occasions each. We reduced our Treasury bill holdings by more than $2 billion over the interval, largely through sales of $900 million to foreign accounts and the redemption of $800 million of maturing bills. Our ability to sell bills to foreign accounts under matched transactions also enabled us to absorb inconspicuously another $300 million, on the average, during the period. Our dominant role as the agent for foreign central banks in the market for Treasury securities once again proved very useful in the conduct of domestic operations.

I would note that the Treasury's sale of an 18-day bill for cash on August 7 proved very helpful to reserve management. As a result of this innovative financing, the Treasury's borrowing at the Reserve Banks did not even approach the $3 billion leeway provided by the Committee's August 6 amendment to the Authorization for Domestic Open Market Operations. At the time we requested the increase in the leeway, we did not yet know about the Treasury's plan for this special borrowing. On August 6 we were asked by the Under Secretary whether or not the Desk could handle the offering of $1 billion of a special Treasury bill on the following day. That was rather short notice, but we agreed to do it, and the Treasury announced the offering that afternoon. Tenders of $10 million and up were submitted to the Federal Reserve Bank of New York the next day, and the Treasury received payment on August 8. I think the Treasury is very properly pleased that over $6.0 billion in tenders were received, and the average rate of 6.28 per cent was very close to the Federal funds rate. We at the Desk hope that the Treasury will build upon this successful experiment by offering short bills from time to time in the future as a means of steadying out their wildly fluctuating cash balance.

Despite the steadiness in the money market during the recent past, the credit markets have been buffeted by strong waves of apprehension. Treasury bill rates have risen by about 40 basis points in the 3-month area and by almost 100 basis points in the one-year area. Yields in the 2-year area are up about 90 basis points. Long-term bond yields have risen 40 basis points, with corporate bonds performing similarly. In fact, a sizable volume of corporate issues was postponed because of unsettled market conditions. In the municipal market, yields of many issuers have risen to peak levels. New York State's Municipal Assistance Corporation was able to raise money to meet New York City's August cash needs by only the narrowest of margins.

The Treasury's cash requirements and the problems of New York City both proved more disturbing than most credit market participants had anticipated. Further evidence of economic recovery and disquieting news from the price front made underwriters in all markets anxious to move securities out to final holders as speedily as possible. Investors in Treasury securities, of course, have been able to choose among frequent offerings involving a variety of maturities, and they are amply assured of additional investment opportunities if they do not acquire the current offering. The Treasury has, in fact, raised $8 billion in cash since the last meeting. Adding to that the $2 billion of bills that we have sold from the System Account, the market has had to absorb over $10 billion of securities in a short period. Government securities dealers and other underwriters suffered substantial losses when prices fell as they stepped up their distribution efforts because of renewed concern about the outlook for inflation. Big Mac's well publicized difficulties added significantly to the desire of all underwriters to limit their risk exposure.

The Treasury's financing calendar still poses some near-term challenges to the market's absorptive capacity--namely, the auction of $2.2 billion 1-year bills tomorrow and the sale of $2 billion of 49-month notes on Thursday. On the other hand, the Treasury's cash flow will enable it to rebuild its balance at the Federal Reserve, and we expect to be supplying a sizable volume of reserves over the next few weeks. We would plan to be buying coupon securities in some volume in this process, and in fact this afternoon we will be buying Treasury agencies for delivery on Thursday, when we will be moving into the period of reserve needs.

Chairman Burns remarked that, on the basis of weekly averages, the Federal funds rate had risen 93 basis points from its low in June to the level in the week ending August 13. Over the same period, the 90-day Treasury bill rate and the one-year bill rate had risen 139 basis points and 162 basis points, respectively. Those differential rates of increase had profound implications, which the Committee might want to take into account when it considered policy later in the meeting.

Mr. Kimbrel asked if the Desk could determine whether the market was more disturbed at the moment by the increases in interest rates that had occurred or by the possibility that rates would be held down and inflationary expectations would intensify.

In reply, Mr. Holmes observed that both concerns existed in the market. There were those who believed that the Federal Reserve would hold interest rates down and thereby raise the rate of inflation. At the same time, however, the large volume of new Treasury securities in the market had been an important factor. In several successive Treasury auctions--not including the latest one--dealers had tended to bid prices up too high and then, finding no active secondary market, had taken losses.

Mr. Baughman asked whether the coming period of reserve need would be very short or would be of longer, seasonal duration. His basic interest was in whether the period ahead might be an appropriate one in which to consider a change in reserve requirements.

Mr. Holmes replied that the need to provide a substantial volume of reserves would persist for about 3 weeks. After an interruption of a few weeks, the need for reserves would reappear. He believed that a sustained period of reserve need would occur later in the year. He might note that the old seasonal factors for reserves had not been appropriate recently, because of the large shifts in Treasury balances. That was one reason why he hoped that the Treasury would use its latest financing innovation to lessen fluctuations in its balance.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period July 15 through August 18, 1975, were approved, ratified, and confirmed.

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

> Our overriding problem in formulating the blue book[1] alternatives[2] this time was the need to adjust to the prospect of a substantially stronger recovery in economic activity than was expected 5 weeks ago. As Mr. Gramley has explained, staff projections of both real output and the rate of inflation have been raised for the next several quarters. The result is that the increase in nominal GNP is now expected to be at annual rates of around 15, 17, and 14-1/2 per cent, respectively,

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

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

in this and the next two quarters. Given the Committee's longer-run targets for monetary growth, as indexed by a 5 to 7-1/2 per cent rate of expansion in M_1, the implication is that interest rates will have to rise strongly in the period ahead.

All of the alternatives, therefore, are presented in the context of a probable need for a program of gradual tightening in money market conditions into the fall and winter months. It is extremely hard to know how high short-term rates will have to go, since much will depend on the extent of the economies that develop in the use of cash balances and the precise strength and character of the credit demands that emerge. But given the size of the disparity between growth in nominal GNP and money, we are inclined to believe that the Federal funds rate would need to rise above 10 per cent by early next year if M_1 growth were to be held to about the 6-1/4 per cent midpoint of the one-year target range.

Because the pressures on money markets arising from this steep rate movement seem excessive for this stage of the cycle, and also because a part of the larger expansion in GNP--and hence in money demand--results from exogenous increases in fuel and agricultural product prices, we have incorporated estimates of the effects of permitting money growth over the next year to be in the upper part of the Committee's target range. This also is likely to require an upward trend in interest rates, but less markedly so; the funds rate might need to rise to something on the order of 9 per cent by early 1976. In addition, we have assumed an increase by around year-end in Regulation Q ceilings on longer-term certificates, which helps to sustain growth in the broader measures of money at approximately the minimum rates acceptable to the Committee.

These patterns of interest rate and financial developments underlie the longer-run monetary growth numbers associated with alternatives A and B, while alternative C is thought to be most consistent with maintenance of a 6-1/4 per cent M_1 growth objective. In the very short run, of course, there is no necessary relationship between the 2-month specifications of the alternatives and the longer-run objectives of the Committee. But the longer the needed movement in rates is moderated or delayed, the larger will be the subsequent adjustment necessary in order to achieve the desired goals. This is particularly so when one takes into account the lags that appear to exist before a given change in money market conditions significantly modifies what otherwise would be the rates of monetary growth that the economy itself produces.

As it happens, the money growth rates projected for the August-September period are not especially alarming under any of the alternatives presented. This is so because the early August data have remained on the weak side, as balances continue to adjust to the rapid build-up that occurred in May and June. But we believe that the underlying growth in the demand for money is stronger than the current figures suggest, and that these demands will be accelerating with the increasing pace of GNP expansion. If so, it will be relatively easy to fall behind in limiting the monetary growth rate, and quite difficult subsequently to get it back down within the Committee's target range.

Aside from the relative flatness of the current numbers, one other consideration argues for maintaining about the current money market conditions for a while longer. This is the obvious distress of the municipal securities market, and the effects that concern about a possible default by New York City are having on the quality consciousness of investors everywhere. It seems doubtful to me that a stable money market would do much to help with the risk aversion problem, and it is dangerous to run the risk of being too expansive now, since the System may be forced to pump in substantial excess reserves through the window or in other ways later on if there is in fact a New York City default. But it may be that the Committee will wish, as a first priority matter, to avoid the appearance of a further firming up in its posture in these weeks that may come to be viewed as immediately preceding a financial market crisis.

Mr. Balles asked how much confidence the staff had in its projections of interest rates, which were frighteningly high, and how much of the projected increases in rates reflected inflationary expectations in addition to the pressure of strong demands for funds against modest supplies of money and credit.

Mr. Partee replied that growth in nominal GNP at about the pace projected--which he thought was a reasonable expectation--inevitably would bring about substantially higher interest rates in the first half of next year. He believed that rates would be especially high if the rate of growth in M_1 was at the midpoint of the Committee's longer-run range, as under alternative C--rather than near the upper limit of the range, as under alternatives A and B--because the implied increase in the velocity of money was unprecedented in the postwar period. Actually, the econometric model had yielded still higher rates, but the staff believed that the model tended to overstate rate increases. With respect to inflationary expectations, they were taken into account in the level of interest rates, but the projected increase in rates was based on the expected demand-supply relationship.

Mr. Partee added that, even after allowance for inflationary expectations, high levels of nominal interest rates still had contractive effects in some sectors of the economy because of institutional constraints. The flows of funds between deposits in thrift institutions and market instruments were influenced by differentials in nominal interest rates, which had consequences for the housing market.

Mr. Wallich remarked that he had had some calculations made which suggested that for an expected Federal funds rate of

10 per cent, the 90 per cent probability limits were 2.8 percentage points in either direction. Thus, for an expected rate of 10 per cent, the probabilities were 90 per cent that the actual rate would fall between 7.2 and 12.8 per cent.

Mr. Eastburn commented that he had found it helpful to have the numerical projections of the Federal funds rate for early 1976 that were contained in the blue book prepared for this meeting. While he recognized the difficulties in making such projections, he hoped the staff would continue to provide them.

Mr. Mayo asked why, under all three alternatives in the blue book, the projected rates of growth in the bank credit proxy over the second half of 1975 were low in relation to growth in M_1.

Mr. Partee replied that the growth projected in the credit proxy did appear quite low, but there was a reasonably strong argument in support of the projected rates. It was expected that banks would not seek funds through the sale of negotiable CD's or from other nondeposit sources so long as business loan demand remained weak, and the flow of funds projections continued to suggest a low rate of business loan growth in the second half of this year. In his opinion, however, business loan demand was likely to pick up after the turn of the year, and he personally would have projected somewhat higher growth rates for the proxy in the first half of 1976.

Chairman Burns then suggested that the Committee turn to its discussion of monetary policy and the directive. He might note that today's decision would not be a simple one because of all the uncertainties surrounding financial markets. He invited Mr. Volcker to open the discussion.

Mr. Volcker remarked that, as the newest member, he was not yet comfortable with the Committee's approach to policy-making in terms of alternative ranges for the Federal funds rate and various monetary aggregates. He thought a case could be made for a little tightening, however defined, at this time--namely, that moving gradually toward restraint would reduce the risk of having to move abruptly later. Clearly, the lags and the uncertainties associated with the impact of monetary policy actions had to be taken into account. Nevertheless, as others had noted, the unsettled conditions in financial markets--particularly the municipal market--were a matter of concern in the current economic environment.

In his judgment, Mr. Volcker continued, the current sensitivity of financial markets was attributable to uncertainties of several kinds, relating to the rate of inflation; to Federal Reserve policy and the future course of interest rates--particularly in light of the recent tightening; and to the fiscal problems of New York City. New York's problems were having an adverse impact on weaker borrowers, not only in the market for municipal securities, but to a degree in other markets as well. Moreover, the recent resumption of large-scale Treasury financing--while not unexpected--had served as a reminder of the heavy volume of such financing in prospect.

Because the over-all situation was sensitive, Mr. Volcker said, it was possible that an overt move by the System could create more restraint in the short run than intended. The importance of that consideration depended on one's relative confidence in the near-term business outlook. It was unlikely that a firming action would abort the recovery, but there was a chance that it would do so.

Mr. Volcker remarked that the underlying problem was, of course, the trade-off mentioned by Mr. Balles between employment and the rate of price advance. Like Mr. Balles, he had heard reports of businesses that intended to raise prices as soon as possible. An optimist would be encouraged by the projections for reduced inflation emanating from some econometric models. Some models even suggested that a significantly lower rate of inflation could be achieved--at least in the next 18 months or so--by stepping up the rate of growth in the economy. The logic was that faster economic growth would generate increased productivity and, therefore, less pressure on unit labor costs. While some analytical arguments could be advanced in support of such projections, he was not prepared to accept them--primarily because the models did not take adequate account of the important factor of expectations. Moreover, the lag in the effect of policy actions on prices might be so long that action taken now could result in renewed inflation more than 18 months from now--that is, in a period beyond that covered by most econometric projections.

In sum, Mr. Volcker observed, he would not favor an overt move in either direction at this time. He did not want to give a signal of easing because he would be concerned about the impact on inflationary expectations. And, as he had indicated, he was apprehensive about the possible effects of a signal of tightening, given the sensitive state of financial markets. Therefore, since the projected rates of growth in the monetary aggregates seemed reasonable--for the short run, at least--he would maintain the present policy stance until next month, when further developments could be evaluated.

Mr. Jackson remarked that, while the relationship between monetary policy and economic growth might be somewhat tenuous, that between monetary policy and conditions in financial markets was quite close. The state of financial markets, in turn, affected business decisions; market conditions were particularly important at a time like the present, when inventory accumulation was expected to be a major factor in the economic recovery. Given the sensitive conditions in financial markets and especially the problems being experienced by some financial intermediaries, he would favor maintaining the present stance of policy for the period until the next meeting, while awaiting more solid evidence on the rate of growth in the economy.

Chairman Burns observed that he had a great deal of sympathy with the views voiced by Mr. Volcker, and it appeared that Mr. Jackson's thinking ran along similar lines. There was no need for him to repeat any of the arguments that Mr. Volcker had advanced. Instead, he might suggest certain numerical specifications to help focus the Committee's discussion.

For the monetary aggregates, the Chairman continued, he would suggest that the Committee adopt the 2-month ranges of tolerance specified under alternative B. For the Federal funds rate, he would set a range of 5-3/4 to 7 per cent. However, he would not specify the 6-3/8 midpoint of that range as the objective for open market operations; rather, he would instruct the Desk to maintain the funds rate in the present 6-1/8 to 6-1/4 per cent area, aiming at a higher or lower rate only if justified by significant movements in the monetary aggregates. If a tendency for strong monetary expansion should develop, a move to the 6-3/8 per cent midpoint of the range might be appropriate. Since it appeared necessary to proceed cautiously under current circumstances, he would prefer that the Desk not go beyond that point without further deliberation by the Committee.

Mr. Mayo observed that he preferred the 5-1/2 to 6-3/4 per cent funds rate range specified under alternative A, but he could accept the 5-3/4 to 7 per cent range suggested by the Chairman. His preference for the alternative A range, with its 6-1/8 per cent midpoint, was based on the same reasoning as that underlying the Chairman's suggestion--that a strong argument could be made for maintaining the funds rate at about its current level. For the Committee to permit increases in the funds rate any larger than contemplated under the Chairman's proposal would, in his judgment at least, serve to ratify increases in short-term interest rates that seemed to have anticipated another tightening move by the System; the recent upward trend in the prime rate, for example, appeared to be premature in terms of the economic realities, at least from his vantage point in the Midwest. In sum, although he favored the short-run specifications of alternative A, he could accept those proposed by the Chairman as consistent with his preference for a longer-run target for M_1 of about 7-1/4 per cent--near the upper end of the 5 to 7-1/2 per cent range the Committee had adopted.

Mr. Kimbrel remarked that his views on policy differed slightly from those of Mr. Mayo. He continued to be concerned about inflationary expectations, as indicated by his earlier question to Mr. Holmes regarding the relative weight the market seemed to be placing on the prospect for higher interest rates and on the outlook for increased inflation. He could accept the specifications suggested by the Chairman with one exception--he would be inclined to allow the Desk to move, gradually and delicately, toward the midpoint of the proposed Federal funds range. Such an action would help to reassure market participants that the Federal Reserve had not abandoned its anti-inflation posture.

Mr. Bucher said that until just a few days ago his views had been very much like those expressed today by Messrs. Volcker and Jackson and endorsed by Chairman Burns. Most recently, however, he had begun to lean towards the position just expressed by Mr. Kimbrel. After several months of serious doubts about the prospects for recovery, he was now satisfied that a recovery of the sort projected by the staff was on its way. Indeed, he now shared the view that, if the staff's projections were wrong, the error was more likely to be on the low than on the high side.

Mr. Bucher remarked that he had not lost sight of two important implications of higher interest rates, which the Committee had to continue to keep in mind. First, higher rates would have adverse effects on housing, on business fixed investment, and on the stock market--and through the stock market on consumer psychology. Secondly, and perhaps more importantly, higher interest rates could have a serious impact on the ability of New York City to continue to meet its financing needs from month to month in an environment where potential buyers of its obligations had serious doubts about its solvency. In his judgment, however, the inflationary psychology that now seemed to be building up again carried implications that were potentially more damaging than those considerations.

Accordingly, Mr. Bucher observed, he thought the Committee should edge toward firmer money market conditions, moving carefully and in concert with its perceptions of monetary aggregate growth rates and of money market sensitivity. In short, he favored a slightly more restrictive monetary policy at this point. He had no quarrel with the 5-3/4 to 7 per cent Federal funds rate range proposed by Chairman Burns, but he would advocate a somewhat earlier move toward the midpoint of that range than the Chairman had suggested. With regard to the financial markets, and particularly to the situation in New York City, he thought the Committee should watch day-to-day developments closely and should stand ready to react if serious repercussions appeared to be resulting from Federal Reserve actions or other events.

In essence, Mr. Bucher remarked, he was becoming less concerned about the risk that System actions would abort the economic recovery and more concerned about the longer-run implications of policy actions--particularly the potentially difficult task of having to restrain growth in the monetary aggregates to desired rates in early 1976 by fostering sizable increases in interest rates. He continued to favor a 5 to 7-1/2 per cent range for the longer-run growth rate in M_1, but he was inclined toward a rate near the top of that range as suggested in alternatives A and B.

Mr. MacLaury observed that he agreed with the staff GNP projections shown in the green book, except that he shared the Chairman's view that the tapering off in GNP growth forecast for the second half of 1976 might not occur. Unlike the Chairman, however, he thought the Board staff was a little too pessimistic about the price outlook, primarily because he was more optimistic than the Board staff about future gains in productivity. While he could not accept his own staff's forecast of productivity gains in the range of 9 or 10 per cent, the 3-1/2 per cent gain he understood was built into the Board staff projections seemed too low to him. A reasonable expectation would be somewhere between those two forecasts--perhaps 5 or 6 per cent.

In addition, Mr. MacLaury remarked, he could not agree with Mr. Kimbrel and others who thought that the price increases announced by some basic industries like steel and aluminum would be widely emulated. He had heard it said that there were three phases of pricing policy corresponding to phases of a business cycle. In a recession it was futile to reduce prices because sales would be sluggish in any case; during the phase comparable to the current one, when some signs of strength were emerging, it was necessary to reestablish margins in order to generate profits; and in the phase of rapid economic expansion increased sales volume would generate profits so that additional price markups would not be necessary. He thought there was some logic to that description of pricing policy.

Chairman Burns commented that the description seemed plausible. He might note, however, that historically wholesale prices had tended to begin rising at or near the lower turning point of the cycle and to continue rising throughout the expansion period. In the current situation the economy was entering the expansion phase with an inflation rate of about 6 or 7 per cent. It seemed reasonable to him, in light of historical experience, to expect the rate of inflation to increase or at least to remain steady. He wondered why Mr. MacLaury expected the rate to diminish--and to diminish even more than the Board's staff had projected.

Mr. MacLaury said he could support his views only on the ground that the recent past had been characterized by some unique circumstances which set it apart from previous recession periods. Not only had interest rates and the rate of inflation been higher at the trough than at comparable points in earlier recessions; but also, the period of reduced productivity gains had been more protracted in the recent past than in prior cyclical downturns, at least to the best of his knowledge. Although he recognized that periods of little or no gain in productivity were typical of recessions, he felt that in the current cycle businesses were particularly aware of the need for increased efficiency. Consequently, he thought they would seek to achieve increased output--and this was the crux of his argument--while limiting increases in their work force. Although he had no proof, that in essence was his answer to a difficult question.

Turning to the problems of New York City, Mr. MacLaury said he thought that situation would be a threat to financial markets regardless of Federal Reserve policy. Certainly an abrupt move toward a restrictive monetary policy could exacerbate the situation, but he would not be deterred from a gradual move toward restraint--if the economic situation should warrant such a policy--by that particular problem.

Mr. MacLaury observed that he considered a 7-1/4 per cent longer-run path for M_1 to be appropriate. With respect to the short-run specifications, he had been prepared to advocate those of alternative B; the front-end loading involved in the alternative A specifications would only make problems for the future. However, he could readily accept the modified funds rate range of 5-3/4 to 7 per cent suggested by the Chairman. He could also go along with the Chairman's proposal to maintain the present level of the funds rate unless the aggregates were growing strongly, and to move beyond the 6-3/8 per cent midpoint of the range only after further deliberation by the Committee. If the monetary aggregates appeared to be growing at rates near the upper limits of the alternative B ranges, he probably would be prepared to argue that the funds rate should be moved toward the 7 per cent upper limit of its range.

Mr. Mitchell expressed the view that the Committee faced a difficult task today for reasons similar to those underlying the problems the staff had encountered in formulating its recommendations to the Committee. In the current environment, it was not easy to be satisfied with any decision. He agreed with the staff's economic projection for the remainder of this year; indeed, he probably had more confidence in the forecast for that period than the staff itself had. Given the current path of monetary policy, however, he thought the economic situation subsequently would deteriorate much more rapidly than the staff projection implied. That judgment was an intuitive one and perhaps should not be given too much weight.

Mr. Mitchell said he had found illuminating an earlier comment by Mr. Wallich to the effect that momentum generated by the resumption of inventory accumulation could be transferred to other sectors of the economy. To his mind, that was precisely the goal of monetary policy--to create a monetary climate in which the effects of such a stimulus could be transmitted to various other sectors. He was afraid that interest rates of 10, 12, or 14 per cent would transmit nothing but recession.

As for the appropriate posture for monetary policy in the inter-meeting period, Mr. Mitchell said, he thought the newest members of the Committee--Messrs. Volcker and Jackson--had given good advice. The Chairman had quickly recognized that and had proposed a set of specifications which reflected their views. While his own preference had been for the specifications of alternative A, he could accept the Chairman's formulation. He would not, however, want to be associated with any policy stance that called for greater restraint.

Mr. Holland remarked that, in contrast to his view earlier in the summer, he now believed the recovery was firmly enough entrenched to allow some maneuverability in policy. Moreover, the outlook now appeared more inflationary than earlier. The effects of the special Treasury disbursements on growth in the monetary aggregates appeared to have about run their course, so that changes in the aggregates were now more meaningful than in recent months.

It was his feeling, Mr. Holland continued, that at this meeting or the next the Committee should rework its instructions to the Board staff regarding the monetary policy assumptions to be employed in their projection work, and also its operating instructions. With respect to the policy assumptions, he thought it would be improper to plan on validating completely the exogenous price increases discussed earlier today. However, while the magnitude of the exogenous shock was a matter for debate, it was likely to be sizable enough to warrant partial accommodation.

Chairman Burns remarked that any substantial accommodation of those price increases in the short run should be worked out of the system over a somewhat longer period. To do otherwise would be tantamount to giving up the battle against inflation.

Mr. Holland concurred. He added in passing that he had reservations about the appropriateness of M_1 as an indicator of aggregate behavior, but that was a matter the Committee might want to turn to later; for the present, he could communicate his general intention in terms of M_1. The amount of initial accommodation he had in mind was an increase in the 12-month M_1 target of about 1/2 or 3/4 of a percentage point--that is, from the 6-1/4 midpoint of the 5 to 7-1/2 per cent range to about 7 per cent. That was less than the staff had assumed in its latest GNP projection, and it would accommodate about half of the effect of the exogenous price increases as estimated by the staff. He would like to see next month's staff analysis based on the assumption of an M_1 target growth rate of about 7 per cent. Whether such a decision would call for an announcement of a change in the target ranges the Committee had adopted earlier was largely a matter of the effect desired on public attitudes. The Committee might want to make clear that it was aware of the need to make some allowance for the price developments in question; alternatively, it might give priority to the risk that such an announcement could significantly worsen inflationary expectations.

The Chairman observed that in testimony on the matter he had indicated that, in principle, a substantial exogenous shock should be accommodated in the short run--not wholly but partly--with the expectation of gradually working the adjustment out of the system over some period of time. He considered that principle to be conceptually sound. However, it might well prove to be a counsel of perfection that was difficult to carry out in practice, given the uncertainties typically attaching to monetary policy decisions.

Chairman Burns added that the subject of external price developments involved a great deal of guesswork at this point. No firm information was available as yet on the Russian grain harvest, and it was not possible to say what actions the OPEC countries would take with respect to the price of oil. The Board staff had made one projection of the OPEC price increase, another report he had seen suggested a larger increase, and there was some possibility that the price would not be raised at all. To proceed on the basis of the information now available obviously would be premature. Although he agreed with Mr. Holland in principle, acting on that principle would involve a degree of fine tuning that, in his judgment, was beyond the Committee's power.

Mr. Holland said he was concerned that if the Committee did not modify its targets from time to time as it saw cause, it would become entrapped in a framework that grew progressively more rigid. It was necessary for the staff to use some single growth rate for M_1--such as 6-1/4 per cent--in developing its projections, and he thought it would be better for them to use a rate that made some allowance for exogenous price developments than one that did not.

Chairman Burns said he doubted that the Committee was prepared to change its longer-range targets today; it certainly would not want to make such a change without a thorough discussion. If Mr. Holland was suggesting that the staff be asked to develop an alternative GNP projection to be presented along with the projection based on a 6-1/4 per cent rate of growth in M_1, he would see no difficulty. But a suggestion to abandon the GNP projection based on a 6-1/4 per cent growth rate would be premature.

Mr. Holland remarked that his purpose was to open the discussion of longer-run targets today as a prelude to a general debate on the matter at the next meeting.

The Chairman noted that his next testimony under the Concurrent Resolution would be before the Senate Banking Committee on or about the first of November and that it would be desirable for the Committee to review its longer-run targets before that date. In addition to today's meeting, both the September and October meetings would offer opportunities. He asked the members to indicate their preferences with respect to the time at which the longer-run targets should be reconsidered.

Five members expressed a preference for reconsidering the longer-run targets at the September meeting and six favored the October meeting.

Chairman Burns said the discussion would be scheduled for the October meeting. However, the members should feel free to express views on the longer-run targets at any time. He might note in passing that a deviation from the 6-1/4 per cent midpoint of the current 5 to 7-1/2 per cent range for the growth rate in M_1 could be agreed upon without changing the range.

Mr. Holland expressed the view that such flexibility was quite valuable. The Committee tended not to change its longer-run target ranges easily, perhaps partly because there was some flexibility within the ranges. Those targets involved important concerns, however, and he agreed that comments on them should be aired whenever relevant, and not just at meetings at which they were considered formally.

Turning to the Committee's instructions to the Manager, Mr. Holland noted that the operational paragraph of the directive issued at the previous meeting called for maintaining "about the prevailing bank reserve and money market conditions," subject to a proviso clause regarding growth in the monetary aggregates. If the Committee continued to use a money market focus in its directives, it would soon find itself calling explicitly for increased interest rates--assuming that the present expectation of strengthening money demands was borne out. Since such a directive would be subject to the misinterpretation that the Committee sought higher interest rates as an end in themselves, he would favor returning to directive language that focused on the desired pattern of growth in the monetary aggregates. Such language was contained in the "substitute wording" shown in the drafts distributed by the staff. For the numerical specifications, he could accept the ranges proposed by the Chairman. Although he was prepared to allow some firming in the Federal funds rate if warranted by the rate of growth in the aggregates, he was quite agreeable to the course of prudence embodied in the Chairman's proposal with respect to the relation of movements in the funds rate to changes in the aggregates.

Mr. Wallich said he shared Mr. Holland's view that the exogenous price increases had to be validated to some extent by monetary policy. He thought, however, that the time to do so was not now but later, when the pressures became more pronounced. He would withstand some pressure now in order to have more leeway later. It was partly for that reason that he preferred to review the longer-run targets in October rather than in September.

With respect to short-run specifications, Mr. Wallich observed, he found the alternative B ranges for the 2-month growth rates in the monetary aggregates to be quite acceptable. The alternative B ranges were a little below the Committee's longer-run targets because of the relatively low growth now projected for August, but that might be offset by somewhat stronger than expected growth in September. He shared Mr. Holland's view that the directive should focus not on money market conditions but on the desired rate of growth in the money supply.

Mr. Wallich remarked that there had been a rather marked rise in interest rates recently, and he saw no immediate need to push further in that direction. He could accept the 5-3/4 to 7 per cent range for the Federal funds rate suggested by the Chairman; although his first choice would have been a range with limits a quarter of a point higher, he did not consider that difference very significant. Also, he would favor maintaining the funds rate near its present level in the absence of strong movements in the aggregates. Although it should not be a decisive consideration, he would give some weight to the fact that interest rates were declining in other industrial countries, so that increases here might create some problems in the international sphere.

Mr. Morris said he might first note that he shared Mr. MacLaury's view that the problems of New York City should not be given heavy weight in today's policy decision. In his judgment, the problem was one of confidence; the City would have difficulty marketing its bonds even in a strong market.

Chairman Burns agreed that New York City would have problems in any case. However, Federal Reserve policy could certainly intensify the difficulties in markets for municipal securities--difficulties which were not limited to New York City. There had been a ripple effect in the municipal market; New York State issues, for example, had become tainted by the problems of New York City, and other issues had also been affected, as evidenced by the progressive widening of the interest rate differential between the highest and the lower grade municipal bonds.

Mr. Morris then remarked that he favored the specifications of alternative A because he questioned whether the economy would be as strong in the fourth quarter as the staff had projected. He was impressed by the substantial contrast between the financial facts and the financial projections presented at this meeting.

In recent months a relatively stable Federal funds rate had been associated with quite moderate rates of growth in the aggregates; since June the annual rates of growth in M_1 and M_2 had been 3.7 and 8.6 per cent, respectively. In that period the System had not had to supply a large volume of reserves in order to maintain the funds rate at prevailing levels. On the contrary, total reserves had contracted slightly over the past few months.

Accordingly, Mr. Morris continued, the case for alternatives B and C lay purely in the realm of projections, not in the realm of available data. Although the projections might prove to be correct, he had found since joining the System that when the Committee acted on the basis of projections unsupported by incoming data it usually made a mistake. Policy actions in the fall of 1968 were a case in point. He thought the Chairman's earlier statement that the staff's GNP projections should be taken with a grain of salt applied with even greater force to the staff's projections of the monetary aggregates. Forecasting techniques were at a much higher level of development for GNP than for the monetary aggregates--particularly for the relationships between interest rates and the aggregates. Even last fall, when the GNP projections had gone awry, those for the monetary aggregates had been further off the mark. Consequently, he believed it would be extremely hazardous for the Committee to change its policy stance solely on the basis of projections of rapid growth in the monetary aggregates.

Mr. Morris observed that he would consider the adoption of alternative B hazardous for another reason--it would clearly put the thrift institutions on the threshold of disintermediation. That threshold had already been reached in Boston, where deposit growth at the nonbank intermediaries had been essentially flat in the latter part of July. He was willing to tolerate some disintermediation if hard data indicated that that was a necessary cost of maintaining reasonable control over the monetary aggregates. But in his judgment, there were no such data at present.

Therefore, Mr. Morris said, he considered alternative A the proper policy at this time. Although he preferred the specifications of that alternative, he could accept those suggested by Chairman Burns because, as he understood the Chairman's interpretation of his proposed funds rate range, it was not essentially different from his own preference.

Mr. Balles remarked that he was frankly perplexed about the appropriate course for policy at this time. If there was one lesson to be learned from history, it was that inflation fosters high interest rates--a point the Chairman had emphasized repeatedly in Congressional testimony. He thought the worsening outlook for inflation had to be of primary concern to the Committee. In view of the staff projection suggesting a stronger economic recovery and more inflation than previously anticipated, he believed that it would be a strategic error for the Committee to resist the rise in short-term interest rates that was inevitable given the current economic outlook. While he would want to move gradually and gingerly, particularly in light of the sensitive state of financial markets, he would consider it an error of the first magnitude for the Committee to continue to emphasize interest rate targets, rather than growth rates in the family of monetary aggregates, as the recovery proceeded.

All things considered, Mr. Balles said, the reformulation of alternative B suggested by the Chairman seemed generally appropriate to him. However, like some others, he would be inclined to allow the funds rate to move up to the midpoint of its range.

Mr. Leonard observed that he could accept the short-run specifications suggested by the Chairman. For the directive he preferred the so-called "substitute" language. With respect to the longer-run target for M_1, he would not favor moving from 6-1/4 to 7-1/4 per cent for three reasons. First, he did not like the idea of validating price increases. Secondly, a 7-1/4 per cent growth rate would yield a level of M_1 in the second quarter of 1976 that he considered higher than desirable. Finally, he was persuaded that a 6-1/4 per cent rate of growth in M_1 over a long period of time would be adequate to sustain the economic recovery. In fact, a 6-1/4 per cent growth rate was quite rapid relative to historical experience. Given the present excessive slack in the economy, however, it was likely to be an appropriate rate.

Mr. Coldwell commented that the System could make its greatest contribution at the moment by fostering stable money market conditions. A tightening move, in his judgment, would have an adverse impact on expectations and would tend to unsettle financial markets, damage housing, and possibly even abort the recovery. While the recovery appeared to be a little more assured now than earlier, it was not yet a certainty. The increases in food and fuel prices were regrettable, but there was not much that monetary policy could do about them. In sum, he favored holding steady in the boat.

Mr. Coldwell observed that in the past the Desk had tended to use only part of the Federal funds range specified by the Committee--up to about 1/2 percentage point or so. He had favored widening the specified range in the hope that the Committee would decide to change that strategy. Since that had not happened, he would suggest that the Committee sharply narrow the range for the coming inter-meeting period, setting it at 6 to 6-1/2 per cent. He could accept Chairman Burns' formulation for the funds rate if it was understood that the Desk would not permit the rate to exceed 6-1/4 per cent without consultation by the Committee.

With regard to the wording of the directive, Mr. Coldwell said that he found the language of alternative A acceptable; he did not like the language of alternative B, which called for somewhat firmer bank reserve and money market conditions. He could also accept the substitute wording for the directive, provided it was interpreted to mean a steady Federal funds rate.

Mr. Volcker remarked that for the short-run ranges he liked the idea of setting the lower limits at levels that were relatively high for the Federal funds rate and relatively low for the monetary aggregates--indicating, in effect, that the Committee did not intend to retreat from its recent firming action. One possibility would be to use the lower limits of alternative B together with the upper limits of alternative A. That would yield a range for the Federal funds rate of 6 to 6-3/4 per cent--somewhat narrower than that proposed by the Chairman--and a range for M_1 of 4-1/2 to 7-1/2 per cent. Perhaps the lower limit for the funds rate might be set at 5-3/4 per cent. Such specifications would imply that the Desk should hesitate to tighten money market conditions but would have some leeway to do so. They would also imply that the Desk should hesitate to ease money market conditions if the aggregates weakened moderately, an approach that seemed desirable in light of the expectation that the aggregates would be strong over the longer run.

Turning to the directive, Mr. Volcker said the language of alternative A, which was quite straightforward, was acceptable to him. He could also go along with the substitute wording, even though it appeared to be about as neutral as any that could be devised. He would object to the language of alternative B or C.

Mr. Baughman observed that the Committee had customarily set a fairly wide range for the Federal funds rate. He would not be inclined to narrow the range at this time unless it was decided to employ narrow ranges regularly in the future. As had been noted, the Manager normally operated within a rather small portion of the range, sometimes in accordance with a specific instruction of the sort suggested today. He favored using narrower ranges as a standard practice, but he would have reservations about doing so at just one meeting.

In response to a question, Mr. Baughman said his fundamental preference was for specifying levels of the funds rate rather than ranges.

Mr. Eastburn remarked that he had been listening carefully to the views of the other members because he thought the Committee had a difficult decision to make with respect to the growth of the monetary aggregates. It seemed to him that two issues were involved. The first was the extent to which monetary policy should accommodate exogenous price increases. He believed it was necessary to accommodate those increases in part; however, because it would probably not be feasible to offset such action fully at a later date, it was important not to be too accommodative. The second issue related to the extent to which the Committee should attempt to take account of the likely future course of interest rates. Despite the many uncertainties involved, he thought it was almost inevitable that an increase in interest rates would be necessary. Accordingly, he believed it would be desirable for the System to anticipate that development and begin moving now.

Mr. Eastburn said his views on those two issues led him to conclude that the specifications of alternative B would be appropriate at this time. He had some difficulty with the Chairman's proposal for limiting the rise in the Federal funds rate because he thought the Manager should have more flexibility. In light of his general policy preference, he did not want to proceed on the assumption that the Federal funds rate would be maintained at about its present level during the coming intermeeting period.

Chairman Burns said he could not recall a meeting where the views expressed around the table had been so similar. To be sure, there were shadings of opinion with respect to specifications, but they involved fine differences--perhaps finer than could be justified by the available knowledge concerning financial relationships.

The Chairman then asked Committee members to indicate informally whether they were agreeable to his earlier proposal to adopt a 5-3/4 to 7 per cent range for the funds rate on the understanding that the rate would not be moved to the 6-3/8 per cent midpoint of that range unless there was clear evidence of strengthening in the monetary aggregates, and that the rate would not be moved above 6-3/8 per cent without further deliberation by the Committee.

A majority of the members indicated that the Chairman's proposal would be acceptable.

Mr. Eastburn observed that, although only a small fraction of a percentage point was involved, the proposed condition for permitting an increase in the Federal funds rate to 6-3/8 per cent could represent the difference between no change and some change in the Committee's policy posture. He wondered if it would be possible to relax that condition; as it had been formulated by the Chairman, the funds rate would rise only in the event of an unusual development.

Chairman Burns said there would need to be no unusual development--just clear evidence of strengthening in the aggregates. He would prefer to leave to the Manager the task of interpreting such evidence.

The Chairman then asked the members whether they would find the specifications for the monetary aggregates shown under alternative B to be satisfactory.

A majority of the members responded in the affirmative.

Chairman Burns then asked the Committee members to indicate their preferences between the language of alternative A and that of the substitute wording, calling for conditions consistent with moderate growth in monetary aggregates over the months ahead.

A majority of the members said they would prefer the substitute wording.

Mr. Baughman referred to the opening sentence in the staff's draft of the general paragraphs of the directive. The statement that real output "had leveled off in the second quarter" struck him as unclear in the absence of any indication of the direction in which output had been moving earlier.

After discussion, the Committee agreed that the sentence should be reworded to state that output had "bottomed out" in the second quarter.

Mr. Mitchell inquired about the practice of including a statement in the directive that was based on a projection, such as the statement in the draft to the effect that output "is likely to increase appreciably in the current quarter."

Mr. Partee commented that in the past the Committee had chosen to include such statements for the current quarter at times when they were warranted by the evidence already available.

Mr. Baughman said he also had a problem with the sentence in the general paragraphs which read: "In July M_1 increased relatively little and growth in M_2 and M_3 slowed substantially as depositors reduced balances built up in May and June in connection with Federal income tax rebates and supplementary social security payments." To his knowledge there was no statistical evidence in support of that explanation of the slowing of growth of the aggregates in July.

Mr. Gramley agreed that direct evidence on the point was lacking. There also was no direct evidence that the previous buildup in the balances during May and June had been connected with Federal income tax rebates and supplementary social security payments. However, the presumption was strong that those explanations were valid.

After further discussion, the Committee agreed that the statement in question should be reworded to read in part: "In July M_1 increased relatively little and growth in M_2 and M_3 slowed substantially, following a sharp increase in depositors' balances in May and June. . .."

Mr. Broida recalled that at the previous meeting some criticisms had been voiced of the statement listing among the Committee's general objectives that of "working toward equilibrium in the country's balance of payments." In light of that criticism, the staff proposed to substitute the phrase "contributing to a sustainable pattern of international transactions," as indicated in the draft text distributed.

No objections to the proposed phrase were raised.

Mr. Volcker noted that there was no reference in the general paragraphs to the financial problems of New York City. In view of the importance of those problems in explaining current developments in financial markets, he thought it would be desirable to add a sentence reading "Financial markets reflected considerable uncertainty stemming from New York City's financing problems."

There was general agreement with that suggestion.

Chairman Burns then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs with the changes the Committee had agreed upon, and the substitute wording for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The ranges of tolerance for growth rates in the August-September period would be 4-1/2 to 7 per cent for M_1, 8-1/4 to 10-3/4 per cent for M_2, and -1-1/2 to -4 per cent for RPD's. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 5-3/4 to 7 per cent, with the understanding regarding current rate objectives that he had proposed earlier.

> By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise authorized 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 output of goods and services bottomed out in the second quarter and is likely to increase appreciably in the current quarter. In July retail sales expanded further and industrial production rose moderately for the second consecutive month, following 8 months of decline. Conditions in labor markets improved further: employment increased, the unemployment rate declined from 8.6 to 8.4 per cent, and the average workweek in manufacturing lengthened considerably. Average wholesale prices rose sharply in July, chiefly because of increases in prices of agricultural and energy products. The advance in average wage rates has continued to moderate over recent months.

In recent weeks the average exchange value of the dollar against leading foreign currencies has risen considerably further, reflecting additional increases in interest rates on U.S. dollar assets relative to rates on foreign currency assets. In June the U.S. foreign trade surplus rose substantially, as exports increased sharply while imports declined slightly further.

In July M_1 increased relatively little and growth in M_2 and M_3 slowed substantially, following a sharp increase in depositors' balances in May and June in connection with Federal income tax rebates and supplementary social security payments. Market interest rates in general have risen appreciably further in recent weeks, in association with indications of strengthening economic activity, more rapid inflation, and large current and prospective Treasury financing requirements. Corporate bond offerings moderated somewhat in July but State and local government offerings continued large. Financial markets reflected considerable uncertainty stemming from New York City's financing problems. Business demands for short-term credit remained weak, although less so than in earlier months.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

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 held on September 16, 1975, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida

Secretary

ATTACHMENT A

August 18, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on August 19, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services, which had leveled off in the second quarter, is likely to increase appreciably in the current quarter. In July retail sales expanded further and industrial production rose moderately for the second consecutive month, following 8 months of decline. Conditions in labor markets improved further: employment increased, the unemployment rate declined from 8.6 to 8.4 per cent, and the average workweek in manufacturing lengthened considerably. Average wholesale prices rose sharply in July, chiefly because of increases in prices of agricultural and energy products. The advance in average wage rates has continued to moderate over recent months.

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In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and contributing to a sustainable pattern of international transactions.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to maintain about the prevailing bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates appear to be growing at about the rates currently expected.

Alternative B

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve somewhat firmer bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates do not appear to be growing at rates below those currently expected.

Alternative C

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve firmer bank reserve and money market conditions over the period immediately ahead, provided that monetary aggregates do not appear to be growing at rates below the specified short-run ranges of tolerance.

Possible substitute wording for all alternatives

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.

ATTACHMENT B

August 19, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications
A. Desired longer-run growth rate ranges (as agreed, 7/15/75): (QII '75 to QII '76)	M_1	5 to 7-1/2%
	M_2	8-1/2 to 10-1/2%
	M_3	10 to 12%
	Proxy	6-1/2 to 9-1/2%
B. Short-run operating constraints (as agreed, 8/19/75):		
1. Range of tolerance for RPD growth rate (August-September average):		-1-1/2 to -4%
2. Ranges of tolerance for monetary aggregates (August-September average):	M_1	4-1/2 to 7%
	M_2	8-1/4 to 10-3/4%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		5-3/4 to 7%

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.