

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 18, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman  
Mr. Hayes, Vice Chairman  
Mr. Brimmer  
Mr. Daane  
Mr. Francis  
Mr. Heflin  
Mr. Hickman  
Mr. Maisel  
Mr. Mitchell  
Mr. Robertson  
Mr. Sherrill  
Mr. Swan

Messrs. Galusha, Kimbrel, Mayo, and Morris,  
Alternate Members of the Federal Open  
Market Committee

Messrs. Clay and Coldwell, Presidents of the Federal  
Reserve Banks of Kansas City and Dallas,  
respectively

Mr. Broida, Deputy Secretary  
Messrs. Kenyon and Molony, Assistant Secretaries  
Mr. Hackley, General Counsel  
Mr. Partee, Economist  
Messrs. Axilrod, Craven, Garvy, Hocter,  
Parthemos, Reynolds, and Solomon, Associate  
Economists  
Mr. Coombs, Special Manager, System Open Market  
Account

Messrs. Bernard and Leonard, Assistant Secre-  
taries, Office of the Secretary, Board of  
Governors  
Mr. Cardon, Assistant to the Board of Governors  
Mr. Coyne, Special Assistant to the Board of  
Governors  
Mr. Williams, Adviser, Division of Research and  
Statistics, Board of Governors

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Mr. Wendel, Chief, Government Finance  
Section, Division of Research and  
Statistics, Board of Governors  
Miss Eaton, Open Market Secretariat Assistant,  
Office of the Secretary, Board of Governors

Mr. Melnicoff, First Vice President, Federal  
Reserve Bank of Philadelphia  
Messrs. Eisenmenger and Tow, Senior Vice Presi-  
dents, Federal Reserve Banks of Boston and  
Kansas City, respectively  
Messrs. Sternlight, Brandt, Scheld, Nelson,  
and Green, Vice Presidents, Federal Reserve  
Banks of New York, Atlanta, Chicago,  
Minneapolis, and Dallas, respectively  
Mr. Bowsher, Assistant Vice President, Federal  
Reserve Bank of St. Louis  
Mr. Gustus, Economic Adviser, Federal Reserve  
Bank of Philadelphia  
Mr. Sandberg, Securities Trading Officer,  
Federal Reserve Bank of New York

Chairman Burns noted that Mr. Mayo was attending his first  
meeting of the Federal Open Market Committee today and said he was  
happy to welcome him to the Federal Reserve family.

Secretary's note: Advices had been received  
of the election by the Federal Reserve Banks  
of Cleveland and Chicago of Mr. Robert P.  
Mayo, President of the Federal Reserve Bank  
of Chicago, as alternate member of the Fed-  
eral Open Market Committee to represent those  
Federal Reserve Banks for the balance of the  
one-year term expiring February 28, 1971;  
and it appeared that Mr. Mayo was legally  
qualified to serve. Mr. Mayo had executed  
his oath of office prior to this meeting.

By unanimous vote, the minutes of  
actions taken at the meeting of the Fed-  
eral Open Market Committee held on July 21,  
1970, were approved.

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The memorandum of discussion for the meeting of the Federal Open Market Committee held on July 21, 1970, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period July 21 through August 12, 1970, and a supplemental report covering the period August 13 through 17, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that since the last meeting of the Committee there had been sizable flows of funds into most of the continental European currencies as well as the Canadian dollar. As American banks had reduced their borrowings from their London branches, Euro-dollar market conditions had eased substantially. Meanwhile, credit had remained tight in most of the continental markets.

Earlier in the period, Mr. Coombs continued, the Euro-dollar market became particularly attractive to German industrial borrowers and the subsequent heavy inflows of dollars into Germany began to erode the restrictive credit policy of the German Federal Bank. Last week the Federal Bank took strong countervailing action in the form of higher reserve requirements, and the prospective new squeeze on German bank liquidity might soon induce a new cycle of German industrial borrowing abroad. Aside from frustrating the

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credit policy of the Federal Bank, such shifts of funds from the Euro-dollar market into Germany were seriously aggravating the U.S. deficit on official settlements account. On the other hand, those shifts did not appear to be creating potential operating problems. As the members might recall, the Germans had sold \$500 million in gold to the U.S. Treasury last winter on the understanding that they could buy that amount back at any time. There were no indications that they were thinking of exercising that option, or even of asking the United States to draw on the swap line or to go to the Fund.

However, Mr. Coombs observed, some operational problems were arising in connection with the Swiss franc. Several weeks ago an informal agreement had been reached with the Swiss National Bank to liquidate the System's Swiss franc swap debt of \$185 million through a package arrangement involving a Treasury sale of \$50 million of gold and Federal Reserve use of \$15 million of Swiss franc balances. For its part the Swiss National Bank undertook to hold on an uncovered basis the remaining \$120 million now covered by an exchange guarantee under the swap. The gold sale had gone through last Friday, August 14, and the remainder of the transaction would be executed as soon as the market rate reached a level at which neither the Federal Reserve nor the Swiss National Bank would suffer a loss on the deal. Meanwhile, however, the Swiss National Bank had taken in still another \$100 million, which would push their uncovered dollar position to a new peak of \$800 million.

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Mr. Coombs thought there was some likelihood that the overall strength of the Swiss balance of payments position, combined with tight money market conditions, would continue to pull dollars into Switzerland. Those inflows could suddenly assume massive proportions if speculation developed over current legislative proposals that would permit the Swiss Federal Council to alter the Swiss franc parity without prior clearance with the Swiss Parliament. He thought, however, that the System could probably count on the cooperation of the Swiss National Bank in avoiding any undue pressure on the dollar if such heavy inflows into Switzerland should materialize.

Mr. Coombs noted that the System also had had to draw a total of \$160 million on its Dutch guilder swap line, leaving a margin of only \$140 million available. The Dutch balance of payments position had been fairly strong for many months past, but the recent heavy flow of funds into Amsterdam mainly reflected speculation on a revaluation of the guilder. Market sources generally attributed that flurry of speculation to a recent report of the Organization for Economic Cooperation and Development which implied that it might have been well for the Dutch to have revalued at the same time as the Germans.

Mr. Coombs reported that System debt in Belgian francs had reached the \$85 million mark as the Belgian current account position had recently shown surprising strength, with perhaps also some sympathetic reaction to speculation on the guilder. There had

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also been a fair amount of market speculation in the Canadian dollar where the rate immediately reflected every new rumor and was providing the more skillful of the market operators with many profit-making possibilities.

In the case of Italy, Mr. Coombs continued, the tourist season had reduced the drain on the Bank of Italy's reserves well below that of earlier months, but the lira remained seriously threatened by the combination of a deteriorating current account balance and capital flight. The dollar balances of the Bank of Italy had now been reduced to a level at which the Bank would soon have to consider whether to reactivate the swap line or to make a new drawing on the International Monetary Fund. In view of the difficulties the Italians faced in holding a government together, much less those of devising an effective stabilization program, the Bank of Italy might prefer to approach the Federal Reserve first. The Bank of England might also find itself compelled before long to draw upon the swap line. Sterling was beginning to sag once again as exports seemed to have leveled off while imports were continuing to rise. He noted in that connection that the rate of wage inflation in Britain was becoming one of the highest in Europe. Still a third possibility, to which he was alerted only yesterday, might be activation of the swap line by the Bank of Mexico. The death last Friday of Governor Rodrigo Gomez, and the resignation of the Minister of Finance, Ortiz Mena, had simultaneously taken from the

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Mexican scene two unusually competent officials. The Bank of Mexico might want to counter any disturbance in Mexican financial markets by strengthening Mexico's dollar reserve position through a swap drawing.

In general, Mr. Coombs said, he could see imbalances developing in the exchange markets which would probably require extensive financing through the swap network between now and year-end. With the exception of the United Kingdom, however, there were available to each country involved very sizable backstop facilities in the way of Fund quotas and SDR's which could be used, if necessary, to pay off swap debt within the traditional maturity schedule.

By unanimous vote, the System open market transactions in foreign currencies during the period July 21 through August 17, 1970, were approved, ratified, and confirmed.

Chairman Burns then invited Messrs. Brimmer, Hayes, and Galusha to report to the Committee on their recent foreign trips.

Mr. Brimmer noted that he had been abroad almost all of the time since the date of the Committee's preceding meeting, having left the country that afternoon and not returning until two days ago. He had spent three weeks of that period in Africa, followed by three days in Denmark. Since he expected to complete a written report on his African trip by next week and would have copies distributed to Committee members, he would touch on only a few highlights today.

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Mr. Brimmer observed that he had visited a number of African central banks, and had delivered an address in Liberia. In that country the U.S. dollar was still circulating as the official currency, and the question of whether or not to establish a central bank was being debated in and out of government. That issue would be resolved next year. All African countries had been extremely disappointed with the basis that had been chosen by the International Monetary Fund for allocating Special Drawing Rights; they had favored an alternative basis under which developing countries would have received a larger share of total SDR's and could have applied them to development financing. Another subject he had discussed was the planned African Development Bank. At some point the United States would have to make a decision regarding the basis on which it would participate in that bank.

In Denmark, Mr. Brimmer continued, he had visited the National Bank and talked with officials about a number of matters. During his stay in Denmark there were news stories regarding a report in a magazine (International Commerce) published by the U.S. Department of Commerce which presented an extremely critical assessment of the Danish economy. Both the American Embassy and the National Bank had expected a question to be raised during the press conference he held following his meeting with the Board of Governors of the National Bank. In particular, the latter thought a question might be raised as to how the Federal Reserve would view its swap line

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with the National Bank if the position of the Danish balance of payments was as bad as reported. However, that question was not asked. On an unrelated matter, Danish officials were somewhat concerned about the possibility of demonstrations by radical elements from Sweden, France, and Germany during the Bank and Fund meetings in September, and they were making plans to cope with any such activity.

Mr. Hayes noted that on his recent visit to the Soviet Union he had been accompanied by Mr. Garvy, and that Mr. Galusha had joined them for part of the time. The primary purpose of the trip, insofar as Mr. Garvy and he were concerned, was to get acquainted with senior officials of the principal national financial institutions of the U.S.S.R., and to learn something about their policies and operations. Mr. Garvy already knew a great deal about those institutions and had met their leaders on his previous trips, whereas he (Mr. Hayes) had arrived in Russia with a minimum of background knowledge.

Mr. Hayes observed that they had visited the State Bank, which performed all the central, domestic commercial, and savings banking functions of the entire country and which had some 300,000 employees. They also had called at the Ministry of Finance, the Bank for Foreign Trade, and the International Bank for Economic Cooperation--the last of which served as a sort of payments union of the Eastern bloc countries. In each case their reception had

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been extremely cordial, and their hosts had made a real effort to enlighten them--in some instances, at their request, through visits to operating departments and branches in addition to oral presentations and answers to their questions. They had learned a great deal, but he should mention two major qualifications. First, the Soviet economic system was so highly controlled by central authority that their concept of banking and credit policy was rather far from that in the United States. There were, however, important similarities also--as in trying to stimulate savings, effecting money payments throughout a huge country, recognizing needs for mechanization, and so forth. The second qualification was that in Russia there was a powerful and inherited tradition of secrecy, which had limited sharply their ability to get far beneath the surface in the conversations. It was, however, worth noting that the head of the Foreign Department of the State Bank had taken great pains to inform them of the essence of the agreement to create a Comecon Investment Bank, information on which was to be released only after the end of their visit.

Mr. Hayes said that no specific requests or business proposals had been put to them at any time. The Moscow Narodny Bank blocked-account grievance had been mentioned, but the Russians had promptly dropped the subject after his brief explanation as

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to why the Federal Reserve was in no position to play any active part in that matter. They had received only negative replies to the questions they raised in various offices as to the prospects for ruble convertibility and Russian participation in the International Monetary Fund and World Bank. The Russian officials seemed to regard their trip, as they did, as an effort to develop some personal contacts that could lay the groundwork for more concrete cooperation at some future date when the circumstances might be more favorable. It appeared clear that the Russians would like to see more trade with the West and more access to advanced Western techniques.

Mr. Hayes remarked that even a two-week stay in Russia inspired one to think he could make a few accurate comments on that huge and mysterious land. There were many sharp contrasts between things that struck one as impressive and hopeful and those that created an image of desperate inefficiency. But he would not take the Committee's time now to go beyond that generalization.

Mr. Galusha observed that after Russia he had visited Rumania and Hungary. In both countries people had been cordial and had given him warm receptions. A number of people had privately expressed views about the participation of their country

in the International Monetary Fund, and had indicated eagerness to exchange information with U.S. officials on the workings of their respective economies. A great desire to develop trade and banking relations was expressed at various levels.

Mr. Galusha added that he had prepared a written report on his trip, copies of which he would be happy to supply on request.

Mr. Solomon then presented the following statement on international developments:

As Mr. Coombs has mentioned, the German Federal Bank last week announced a very high marginal reserve requirement on bank liabilities--40 per cent on demand and time deposits. At the same time, the special reserve requirement on bank liabilities to non-residents was abolished.

The particular difficulty that was faced by the German central bank is notable because it exemplifies a general problem; namely, in a world in which private capital is able to move readily and in huge amounts, how can a country sustain a monetary policy that is significantly tighter or easier than in other countries? We live in a world that is increasingly integrated insofar as capital mobility is concerned but still far from integrated in terms of fiscal policy and other influences that cause differences in the degree of demand pressure, capacity utilization, and inflation.

In the German case, tight monetary policy combined with a high marginal reserve requirement on German banks' borrowings from abroad led German businesses to by-pass the German banking system and borrow directly from foreign banks. A form of disintermediation was occurring across Germany's borders. In the second quarter of this year, German business firms borrowed net \$500 million from abroad. The result was not only to add considerably to Germany's reserves as the foreign exchange was converted into marks for use in Germany, but also to undermine the Federal Bank's effort to

restrict credit-financed expenditures in Germany. The Federal Bank has apparently now decided that it cannot prevent the inflow of foreign funds and it has moved to a highly restrictive policy designed to offset the effects of the inflow. Whether it succeeds remains to be seen. It is certainly possible, as Mr. Coombs has suggested, that the capital inflow will accelerate.

It is worth noting the similarities--as well as the differences--between the current German problem and the problem the Federal Reserve faced last year when U.S. banks were borrowing heavily in the Euro-dollar market as a way around monetary restraint here in the United States. Because of the special role of the dollar in the international monetary system, the inflow of Euro-dollars did not increase over-all credit availability in the United States. But the American banks with branches abroad are also the major lenders to business and their ability to borrow abroad no doubt blunted the impact of Federal Reserve restraint on the availability of loans to the business sector. When the Federal Reserve imposed the marginal reserve requirement on Euro-dollar inflows, we were able to apply it to head office borrowings from branches and to branch loans to American residents. But the Federal Reserve was just as powerless as the German Federal Bank to place an impediment on direct borrowing from foreign banks.

There are, of course, still other channels by which foreign funds can enter an economy and thwart the intentions of the monetary authorities.

Canada faced a similar problem before the authorities there decided to let the exchange rate float. They feared that monetary measures designed to mop up inflows of foreign funds would simply raise Canadian interest rates, which would attract additional funds from abroad.

The problem is a general one.

If the problem concerned only the balance of payments, it would be easier to cope with. That is, the increases and decreases of countries' reserves that result from capital flows induced by differential monetary conditions could be handled by the swap network and other credit facilities and by an adequate supply of reserves.

But the undermining of monetary policy is more difficult to deal with.

What can be done about it?

One approach that has often been suggested is to widen the margin for exchange rate fluctuation around parities. If, instead of the present 3/4 or 1 per cent

margin up and down, the range of possible fluctuation were, say, 2 per cent each way, greater insulation between national money markets might result. At the moment, however, the Common Market countries are talking about narrowing margins among themselves. If they adopt wider margins at all, it would only be when they can all do it together against the dollar--and that may be far off.

Another approach is to impose controls or taxes of one sort or another on capital flows. Certainly the existing U.S. programs to restrain capital outflow, although they are far from airtight, do help to preserve some autonomy for U.S. monetary policy: they limit the outflow of U.S. capital at times when monetary and credit conditions are relatively easy here.

Other countries may turn to some form of restraint on inflows or outflows of capital as a way of preserving some autonomy for their monetary policies. One can guess that the German Federal Bank might have been pleased if it had been possible in recent months to impose a tax (a reverse Interest Equalization Tax) on borrowings abroad by German businesses.

We shall certainly be hearing more and more about this problem as time goes on. The OECD has begun a study of it and it will soon be on the agenda of Working Party Three.

While the United States is fortunate in that its monetary policy is more immune than that of other countries, we are certainly subject to the balance of payments effects of capital flows induced by differential monetary policy. For this reason, as well as our concern for how other countries manage their monetary affairs, I assume that American officials will want to participate actively in the discussion of this problem in the various forums where it is likely to arise.

Mr. Brimmer observed that U.S. banks had substantially reduced their Euro-dollar borrowings recently--some, perhaps, to levels below their reserve-free bases. He asked for Mr. Solomon's views regarding the near-term outlook for such borrowings and the implications for monetary policy.

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Mr. Solomon remarked that, as the members might recall, he had commented on that question at some length in his statement to the Committee at its meeting in late May. As he had noted then, whether individual banks drew down their Euro-dollar borrowings below the levels of their reserve-free bases would depend to a large extent on how dependent they expected to be on the Euro-dollar market in the future; and that in turn would depend in large part on their expectations with regard to rate ceilings under the Board's Regulation Q. On balance of payments grounds, therefore, it would be desirable to keep banks uncertain with respect to Q--although, of course, the Board's decisions in that area should not be determined on those grounds alone. On the more general policy question, he did not think that the possibility of short-term capital outflows should be an overriding consideration in the formulation of monetary policy. In his judgment the best policy stance from the balance of payments--as well as the domestic--point of view was that which would avoid a deepening contraction on the one hand and a resurgence of inflationary pressures on the other.

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

Mr. Partee made the following statement concerning economic developments:

The economy currently is best characterized as being on dead center. True, real GNP rose a bit in the second quarter, but the increase--amounting to 0.6 per cent, annual rate--was so small as to be insignificant. Total industrial production has been unchanged for three months now--May, June, and July--at a level about 3 per cent below the year-earlier peak, with recent output increases in consumer durable goods and materials offsetting further declines in business and defense equipment. Manufacturers' new orders showed little change during the second quarter, after having fallen appreciably in the first. Employment has continued to decline, with reductions in both manufacturing and other lines and involving both production and office workers. But even here the rate of new layoffs has subsided, and insured unemployment--a measure of the jobs situation among experienced workers--has leveled off at about 3.6 per cent of total covered employment.

The presumption now is that the economy will soon be moving upward again, though the recovery may well be delayed and distorted for a time by an auto strike beginning in mid-September. Ignoring the auto strike prospect, which is uncertain and which in any event would be a temporary factor, the staff GNP projection presents our judgment as to the structure and dimensions of the expected pickup. That projection envisages a continued growth in consumption expenditures, at about the first-half average pace, buoyed by the ending of the surtax and some decline in personal saving from the high second-quarter rate, in the face of slower expected expansion in personal income. It depends importantly on a fairly sharp recovery in housing, which already seems to be under way, and on a gradual but marked acceleration in State-local expenditures over the next year. On the other hand, the projection allows for a moderate decline in capital spending from this point on, and for further declines in defense spending involving both procurement and manpower. Inventory investment is seen as an essentially neutral factor until at least early 1971, although there will be cross-currents in product classes and undoubtedly considerable month-to-month variation.

This projection naturally seems to me both reasonable and most probable among the alternative forecasts that might be made at this time, but it must be recognized that there are important uncertainties in the current situation. The most vital, in my view, concerns business capital expenditures. A downturn now seems clearly in process, but we have very little to go on as to how sharp or extended it will prove to be. Virtually all of the factors thought to influence capital spending plans are negative. Markets are soft, profits are down, external funds are still costly and difficult to obtain, liquidity is strained and balance sheets heavy with short-term debt, and capacity is more than ample everywhere except in the utility and perhaps the fuel industries. We have had a protracted period of relatively heavy capital investment, and businessmen must surely now be less optimistic about the resumption of rapid real growth in their markets.

The situation seems in many respects similar to that in late 1957, following which plant and equipment expenditures dropped 20 per cent over the next four quarters. On the other hand, new orders for business capital equipment have declined only moderately to date, with second-quarter order volume 8 per cent below the fourth-quarter 1969 peak, and none of the spending surveys--though all are out of date--has given any indication of a sharp break in spending. Accordingly, we have reduced capital spending over the next year by only 4-1/2 per cent--perhaps 9 or 10 per cent in real terms--though we recognize that the risk is in the direction of a larger decline. If a significantly greater reduction should develop, of course, there would be important secondary effects on consumption, inventory investment, and capital spending itself.

A second major uncertainty concerns the degree of strength that may reasonably be expected of consumer spending. We have followed a middle course in this area, I think, so that consumption could turn out either weaker or stronger than we have projected. July retail sales data do not provide much evidence one way or the other. The advance report is that sales rose moderately, after two months of little change. However, sales in that month could have benefited from an initial response to the ending of the surtax and efforts to beat the price rise for 1971 model cars; and the indicated rise--less than 1 per cent--was not very large in any event.

The case for relative weakness in retail sales is based on the proposition that consumers remain gloomy, that family budgets are hard pressed by inflation, that investors have been hurt by the stock market decline, and that there is widespread concern about possible unemployment or reductions in earnings. The case for greater strength is that consumers have been conservative in their spending for a long time, and that attractive new merchandise or bullish national or international news developments could quickly bring them out of their lethargy. We have assumed simply that the personal saving rate will gradually decline, partly because it was lifted in the second quarter by special income supplements that were not immediately spent and partly because a declining saving rate has typically resulted from a slowing in income growth such as we have projected.

If the outlook is one of essentially neutral consumer behavior and declining business investment, which we believe to be the case, much will depend on actually getting the projected increases in housing and State and local spending. The situation in housing looks quite favorable, with savings flows to the depository institutions much improved recently and building permits already turning up. The sharp July rise in housing starts--occurring entirely in multi-family units--should probably be regarded as an aberration, but even so starts are well above the winter lows. Further increases in residential building seem certain over the year ahead, although there is no way of knowing how important high interest rates and restrictive credit terms, as well as sharply rising construction costs, will prove to be as constraining factors. Similarly, there appears to be a large backlog of State-local capital projects, although the extent to which high interest rates and limited prospects for increased revenues may serve to hold back such programs is not yet evident.

I want to emphasize once again that, even if spending in these areas does accelerate sharply and the staff projection is generally borne out, we do not anticipate a rapid rebound in economic activity. Real growth in the second half of 1970 is expected to be at an annual rate only a little above 2 per cent, barring an auto strike, and then to accelerate to a rate slightly above 3 per cent in the first half of 1971.

Such an increase would be below growth over the same period in the economy's capacity to produce. It would be associated with a further moderate decline in utilization of plant capacity and, given the current emphasis on cost cutting and the prospects for improvement in productivity, unemployment would undoubtedly continue to trend upward. Moreover, the upturn would be starting from a point where there is substantial underutilization of resources, as evidenced by a 5 per cent unemployment rate and an operating rate in manufacturing estimated at well under 80 per cent of capacity. In these circumstances, there is virtually no risk that economic recovery over the year ahead would add to the inflationary problem through stimulation of excess--or even robust--demand in product or labor markets.

It seems to me, therefore, that the need for stimulative public economic policies is clearly indicated. Such policies could generate additional demand for unused resources, and they would provide some insurance against an unexpected deterioration in the private sector, such as in capital spending. Fiscal policy has turned increasingly stimulative in recent weeks and months, but our projections are still for a substantial surplus on a high employment basis in the first half of 1971, even after allowing for another Federal pay raise. This surplus would still be somewhat higher than in calendar 1969, when public policy was aimed at slowing the economy.

Monetary policy has also been moderately stimulative this year, as reflected not only by growth in the money supply fluctuating around 4 per cent but also by the recent actions freeing up bank credit flows and by the irregularly downward movement in short- and long-term interest rates. I still believe that there is a need for more rapid monetary expansion, however, and for a more substantial decline in interest rates. Therefore, I continue to favor the adoption of alternative B of the directive drafts.<sup>1/</sup> This, in combination with the Board's reserve requirement action yesterday,

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

would provide the basis for a financial market environment conducive to a more certain, and a more satisfactory, recovery in the economy over the next year or so ahead.

Mr. Axilrod made the following statement concerning financial developments:

Three distinctive tendencies appear to have characterized financial markets in recent weeks. One has been the very large net inflows of funds to bank and nonbank savings institutions. Banks have, of course, bid rather aggressively for money market oriented funds through offerings of large negotiable CD's. In late June and in July they added, net, about \$1 billion per week to such liabilities. In the first half of August, however, banks have become considerably less aggressive in the CD market--either because their initial restocking after the suspension of Regulation Q ceilings on short-maturity CD's had gone far enough in light of expectations as to interest rates or loan demand or simply because they may have begun to fear a further shortening of the CD maturity structure.

At the same time as banks have bid for a large volume of CD funds, net inflows of other time and savings deposits have also increased very rapidly. In July, such deposits rose on average by almost \$3 billion, or at a seasonally adjusted annual rate of about 18 per cent, one of the largest increases since we have had the series. Paralleling this time deposit increase at banks, net inflows of deposits to savings and loan associations and mutual savings banks were at a 12 per cent annual rate last month, well above the 7 per cent rate of the second quarter, and the largest monthly increase since April 1967.

A second tendency evident in financial markets recently has been for the decline of interest rates that had been under way earlier in the summer to show distinct signs of hesitation. In corporate bond markets during the past week yields have backed up under the weight of a continuing very large actual and prospective volume of public bond offerings. At a little above 8-1/2 per cent on new high-grade offerings, corporate bond yields are currently well below their early summer highs but they remain more than 30 basis points above their lows of earlier in the year. And, reflecting the recent

weakness in the corporate market as well as the sizable overhang of new Treasury issues in dealer hands, yields on intermediate- and long-term Treasury notes and bonds remain about 60 basis points above their late-winter and early-spring lows. In the municipal market yields have dropped fairly substantially in the weeks since the last FOMC meeting, but there too they remain about 35 basis points above earlier lows.

With the summer decline in long-term market interest rates appearing to have lost its momentum, and with that momentum not having carried such yields even back to lows of earlier in the year, traditionally sticky mortgage interest rates have remained quite sluggish despite large net savings inflows to thrift institutions. The recent decline in the implicit yield on 6-month FNMA commitments may presage some general reduction in interest rates on home mortgages themselves. But the yield spread of home mortgages over corporate bonds has not yet improved sufficiently to suggest a very sizable shift toward this type of mortgage under current circumstances on the part of diversified lenders.

A third characteristic of financial markets recently has been the continuing tendency of investors to shy away from lower-quality investments. In the commercial paper market, major financial institutions do not appear to be having much difficulty rolling over maturities, but many less-than-prime borrowers apparently are--and, in total, nonbank-related paper outstanding has dropped by about \$2-1/2 billion over the past two months on the basis of preliminary data and after allowance for the traditional seasonals. Investors in the corporate bond market have also become more selective, as illustrated by the further widening in the yield spread between outstanding Baa and Aaa bonds from around 95 basis points at the time of the last FOMC meeting to around 130 basis points currently.

These various characteristics of financial markets in recent weeks seem to reflect rather generalized precautionary attitudes. Consumers appear to be placing funds in the safest forms of saving, at the expense of market instruments and perhaps to a degree at the expense of current consumption. And those investors choosing market instruments are becoming quite selective. Meanwhile, corporations are still attempting to restructure debt and seemingly to rebuild liquidity. While all this certainly cannot be taken as evidence of a liquidity

crisis, it does add up to an economy whose demands for liquidity, and safety, in one form or another, are large. For monetary policy, this would seem to indicate the need for an above-average generosity in supplying reserves and money and, what is of course closely related, an effort to make credit more generally available. This would encourage interest rate declines and a wider distribution of credit supplies. With cautionary attitudes prevalent, I doubt that the resulting dispersion of funds, at declining rates, through mortgage, State and local government, consumer, and business debt markets would generate inflationary expectations and I believe that the greater diffusion of credit would give more assurance that the projected recovery in economic activity will indeed be achieved.

While it is obviously too early to say much, if anything, about the immediate market impact of the Board's just-announced modest net reduction in reserve requirements, one might expect the announcement to lead to some little easing of credit markets. This might develop in anticipation of the marginal improvement in the reserve positions of the great bulk of member banks. But any significant easing of credit markets is likely to depend on the nature of accompanying open market operations.

Under current economic conditions, and given the financial developments noted earlier, I would tend to think that a continued effort to seek money supply growth up in a 5 to 6 per cent annual rate range would produce a set of credit market conditions that would accommodate liquidity and precautionary demands for funds while also encouraging flows of credit to help stimulate needed additional spending in such areas as construction and State and local government services. The reserve requirement reduction would complement such an open market policy by encouraging banks to move more actively into mortgages and State and local government securities, and in the process contributing to money supply expansion. But to assure the desired money supply growth and the enhanced availability of credit, and to move long-term interest rates down from the still historically high levels, it will probably prove necessary to permit some further easing of money market conditions over the next four weeks--an easing that might be characterized by first moving the Federal funds rate down to around 6-1/2 per cent or so.

In reply to a question by Mr. Morris, Mr. Axilrod remarked that the projections of housing starts given in the green book<sup>1/</sup> probably would have to be raised somewhat if savings inflows to thrift institutions were maintained at something like the recent pace. Mr. Partee added that it was unlikely that savings balances at nonbank institutions would continue to grow at the 12 per cent annual rate recorded in July. However, the staff's current projections of housing starts were only a little higher than those presented in the June chart show, and those projections had been associated with growth in savings at nonbanks at a 7 per cent rate. If growth continued at, say, a 9 or 10 per cent rate, housing starts might well be higher than now projected.

Mr. Hickman asked whether the market might have difficulty in digesting the expected large supply of corporate and municipal securities even if the Federal funds rate was moved down to about 6-1/2 per cent and other money market rates adjusted accordingly.

Mr. Axilrod said he thought that such a reduction in the Federal funds rate--following the Board's reserve requirement action, as modest as it was--would make it considerably easier to market the forthcoming corporate and municipal offerings. It would also reduce the likelihood of anxious selling of Treasury

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

notes and bonds by dealers, although one could not guarantee that such selling would not occur in any case.

Mr. Mitchell noted that in connection with directive alternative B the blue book<sup>1/</sup> specified a growth rate for money of 6 per cent in the fourth quarter. While one might agree that a temporary acceleration of growth in money was desirable, he wondered whether it was necessary for the Committee to commit itself now to a 6 per cent rate through the end of the year.

Mr. Partee expressed the view that adoption of alternative B today would not involve such a commitment, since the Committee could change its target at subsequent meetings. The staff had included data for the fourth quarter in the current blue book because the third quarter was now about half over, and one needed to show what a new path of growth would entail.

Mr. Axilrod added that the Committee's policy decisions for each inter-meeting period presumably were facilitated by information on the longer-run paths for money that appeared consistent with various short-run growth patterns. He then noted that he personally had recommended an annual growth rate for money in the range of 5 to 6 per cent, a range much like that approved at the previous meeting.

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

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Chairman Burns commented that the money supply target the Committee had adopted at its previous meeting was more accurately described as a 5 per cent growth rate--subject to the significant qualification that, if there were any deviations, the Committee would prefer that they be in the upward direction. As to the short-run growth patterns for money, he thought there was remarkably little difference between the weekly figures set forth in the blue book under alternatives A and B for the period until the next meeting. Those figures were identical through the week ending September 2, and in the two subsequent weeks they differed by only \$200 million--an amount that might be considered negligible, given the magnitude of estimating errors.

Mr. Axilrod observed that the identity in the two sets of money supply figures through the week ending September 2 reflected the staff's assumption that changes in money market conditions would affect the growth rate of money only with some lag. The difference between the two average growth rates shown for the month of September--4-1/2 per cent under alternative A and 6 per cent under B--was a meaningful one, he thought. Moreover, the change in money market conditions needed to move toward the more rapid money growth rate under alternative B was sufficiently great, in his judgment, to have a considerable impact on the general atmosphere in financial markets almost as soon as the change was effectuated.

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Mr. Daane remarked that while the Committee formerly had been charged with "money market myopia" he thought it now was guilty of "monetary aggregate myopia." In his judgment the recent sharp focus on what struck him as relatively small differences in aggregate growth rates was misplaced; the need now was not to achieve some predetermined rate of growth of money but rather to move the economy off dead center by reducing interest rates and increasing reserve availability. To sharpen the issue, he would ask the staff what course they would expect open market operations to take if it turned out that, say, a 6 per cent growth rate in money was attainable with no change from prevailing money market conditions.

Mr. Partee replied that that was a question of policy to be decided by the Committee. More generally, he thought it should be noted that the alternative possible growth rates for money set forth in the blue book were, at bottom, simply indexes to alternative sets of monetary conditions--sets which included financial market as well as monetary aggregate variables.

Mr. Axilrod agreed that the question Mr. Daane had posed was a policy matter. If asked for a recommendation, he would suggest that prevailing money market conditions be maintained if they should prove to be consistent with a 6 per cent growth rate in money. He did not think that outcome was very likely, however.

Mr. Maisel noted that the Desk had acted to ease money market conditions in the period since the previous meeting of the Committee--because, as he understood it, growth in money appeared to be falling below target. He suspected that conditions were easier now than they would have been if at the July meeting the Committee had been employing the type of money market target it had used prior to this year.

Mr. Daane commented that if the Committee had been employing a money market target at its previous meeting it might have instructed the Desk to "err on the side of ease," as it often had in the past. He asked whether the outcome would have been different in that event.

Mr. Sternlight replied that in this particular period the outcome probably would not have been appreciably different.

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 21 through August 12, 1970, and a supplemental report covering the period August 13 through 17, 1970. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Sternlight commented as follows:

The past several weeks have been characterized by relative calm in the financial markets, compared with the threatened turbulence earlier in the summer,

in the wake of the Penn Central insolvency and the subsequent rechanneling of funds normally going through the commercial paper market. In the commercial paper market itself, the total outstanding volume has tended to stabilize, both for dealer-placed and directly-placed paper. However, some issuers are finding it difficult to regain their previous share of the market and to pay off bank debt to the extent they would like. And a few have continued to lose ground as investors remain wary and selective. So, while quiescent, one cannot dismiss the possibility of fresh difficulties from this sector.

Elsewhere in the financial markets, a notable development of the recent period was the Treasury's successful combined refunding-cash raising operation. The public subscription for more than \$2.8 billion of a 3-1/2-year issue and over \$1.7 billion of a 7-year issue offered in the exchange testified to some considerable measure of market confidence in current rate levels in the intermediate-term area, while the heavy subscription for the 1-1/2-year note enabled the Treasury to raise more than \$2 billion of net new cash after covering attrition on the exchange portion of the operation. A possible cloud in front of this silver lining is that the dealers still have a substantial inventory of the three new issues. Their holdings were nearly \$1.4 billion the day after the subscription books closed on August 5. By last Friday the total had come down to about \$1.1 billion--indicating some progress, but with a substantial distribution job remaining to be done. The dealer holdings as of Friday included a little over \$500 million of the 7-year issue.

The market in intermediate-term Treasury issues, which was the area in which the Treasury financed, was firm through most of the period, with the new issues trading at premiums as much as 1/2 point above the offering price. Toward the close of the period prices eased back and the premiums declined, but did not entirely disappear.

In the longer-term capital market the recent period showed mixed results. There was a net decline in tax-exempt yields which was aided by bank buying in the wake of enlarged deposit resources and more permissive Internal Revenue guidelines. But there was a rise in corporate yields which partly reversed the price rally earlier in the summer, as additions to the forward calendar disappointed earlier expectations of an abatement in demand for long-term financing. A sizable volume of long-term

Federal agency financing is also adding to the competition for long-term investment funds. The market is having some difficulty in digesting a \$300 million issue of 15-year Farmers Home Administration mortgage participation notes, while a \$200 million 20-year issue of mortgage-backed bonds guaranteed by the Government National Mortgage Association was announced last week for sale toward the end of this month.

Returning to the short-maturity end of the market, Treasury bills have tended to rise a bit in rate despite the slightly easier conditions of reserve availability that I will mention shortly. This came about as dealers, after rebuilding their inventories substantially in July with the help of two Treasury auctions of tax-anticipation bills, subsequently found investor demand a little disappointing. Possibly, the competition with newly issued bank CD's proved more formidable than it seemed to be just after the Q ceiling was suspended on the shorter maturities. Another factor, possibly, was the return of some investors to the commercial paper market, reducing the demand for Treasury bills from those who had turned to them in the more immediate wake of the Penn Central insolvency. In yesterday's auction of 3- and 6-month bills, average issuing rates were 6.53 per cent and 6.59 per cent, respectively, up from 6.39 and 6.44 per cent the day before the last meeting.

A primary concern to the Account Management during the recent period was the performance of the money supply in relation to that anticipated at the time of the last Committee meeting. We also looked at the credit proxy and various reserve aggregates, but it had seemed clear from the discussion that particular attention was to be directed to the money supply, with the objective of achieving about a 5 per cent growth rate--perhaps a little more rather than a little less--in the current quarter. As we found weekly results falling short of the path projected to be consistent with the desired quarterly growth rate, easier money market conditions were permitted and then a little more aggressively fostered. The Federal funds rate came down about 1/2 percentage point for the period on average and most recently has been in the area of 6-5/8 to 6-7/8 per cent.

This move, while distinct and becoming increasingly noticeable to the market, was undertaken cautiously in view of the fact that New York Bank staff projections continued to show a satisfactory growth rate for the

quarter, and in the light of indications that recent money supply data might have understated the effective money supply because of certain technical changes in handling interbank payments. We do not yet have good estimates of what the impact of these practices might have been on the statistics. Adding to the uncertainty, in the weeks ahead we may get some reversal of the impact of certain of these practices which the major New York City banks have been asked to stop.

Whether the recently somewhat easier money market conditions have put us back on the desired path cannot be said with certainty, although it may be noted that the shortfalls from the path were declining as the period progressed and the latest week is even estimated to have slightly surpassed the path. Of course, not too much should be made of a single week's result. To be reasonably confident of achieving a growth rate of 5 per cent or a little over, it would seem from our present vantage point that the easier conditions of recent days should be continued. If additional weekly data should continue to suggest a shortfall from the Committee's objective for the quarter then still further easing would be in order. And, of course, a Committee decision to aim for more rapid growth than was sought last time would presumably call for a more distinct easing.

A point on which we would appreciate receiving any guidance the Committee may have to offer is the weight to be given to the credit proxy in the period ahead. In the recent period that weight was minimal, and this was probably a necessary concomitant of the uncertainty we faced in assessing the reintermediation by banks to fill the gap left by the shrinkage in commercial paper. While some of that uncertainty remains, it may be that the Committee would want to restore some of the attention previously accorded to the proxy.

Yesterday's action by the Board on required reserves was announced after the close of normal trading hours, and as yet there is no general reaction to report. I would expect, on balance, a constructive impact, with the package as a whole probably taken to be a moderate accommodative step. The impact of the added burden on money market banks that have been active in issuing commercial paper through holding companies should be more than offset by the net release of reserves country-wide. The tax-exempt market may benefit particularly. As for meshing this move with open market operations, that question for the most part still lies ahead of us,

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since apart from what one might call "psychological impact" the specific reserve effects of the action do not occur until October 1.

Chairman Burns stated that he wondered whether the reference to "presumably" in a sentence about future policy was inadvertent. He then referred to Mr. Sternlight's comment that the Desk had exercised caution in its easing move partly because of the possibility that statistical problems were producing a downward bias in the money supply numbers. He asked whether the current understanding of those problems was not still in the "guessing" stage.

Mr. Sternlight agreed that that was the case with respect to the amount of the bias. However, he thought the direction of the bias was reasonably clear.

In response to the Chairman's request for comment, Mr. Axilrod said that while the level of the money supply might be biased downward because of the problem Mr. Sternlight had mentioned, it was not clear whether or to what extent the magnitude of that problem was increasing and, therefore, it was not clear what the effect would be on the rate of change in the money supply. Moreover, there had been a sharp drop in Euro-dollar borrowings over the past several weeks. Data were not yet available to determine how much, if any, of the decline might be reflected in reduced overnight Euro-dollar borrowing; but to the extent that it was, there might be some upward bias in recent money supply figures--a counterpart to the apparent downward bias known about for some time that was related to the practice of

running Euro-dollar transactions through Edge corporations. In his opinion, not enough information was available to support any statement about the nature of the net bias, particularly as it pertained to short-term effects on the rate of change in the money supply.

Mr. Sternlight concurred in Mr. Axilrod's observations about the uncertainty of the net impact on the short-term rate of change in the money supply.

Chairman Burns expressed the view that no weight should be given in open market operations to the possibility of bias in the money supply numbers until the uncertainties that had been mentioned were resolved.

Mr. Brimmer noted that in the past at about this time of the year the staff usually had completed revisions of recent money supply statistics--reflecting benchmark adjustments to call report data, revisions of seasonal factors, and occasionally other adjustments needed to deal with accounting problems. He asked when the revised data might be available this year.

Mr. Axilrod said he was not sure, but suspected that the revisions would not be available until autumn--partly because it was likely to take until then to develop adequate information on the kinds of biases he had mentioned earlier.

Mr. Partee added that FDIC data from the mid-year call reports, which were often used along with earlier call report data to make benchmark adjustments for nonmember banks, were not

available as yet. He thought it would be highly desirable to have such data before completing the revision.

Mr. Brimmer said that until the revisions in question were completed he would be dubious about the reliability of any projections extending five months into the future.

Mr. Daane commented that the Committee seemed to be giving the Desk an almost impossible assignment when it couched its instructions in terms of a variable such as the money supply for which the data were so uncertain. In his judgment the Committee could have accomplished much more in the direction of the desired degree of easing recently if it had formulated its instructions in terms of money market conditions. He favored such a course today. Specifically, he proposed the following language for the second paragraph of the directive:

To implement this policy, while taking account of the effects of other monetary policy action, System open market operations until the next meeting of the Committee shall be conducted with a view to achieving somewhat easier conditions in the money and short-term credit markets; provided, however, that operations shall be modified to resist any tendency for money to deviate significantly from a moderate growth pattern.

In reply to a question, Mr. Daane said he personally would like to see net borrowed reserves brought closer to zero.

Mr. Francis observed that, as he had understood the Committee's instructions to the Desk at the preceding meeting, they had involved giving consideration not only to the money supply but also to money market conditions and the even keel constraint. Having participated in the morning telephone conference call during

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the past four weeks, he had closely observed the Desk's operations from day to day; and it was his feeling that the Desk had done an excellent job in carrying out a very difficult assignment.

Mr. Swan noted that Mr. Sternlight had asked whether the Committee now wanted to have greater weight given to the bank credit proxy in the conduct of open market operations. In that connection he (Mr. Swan) wondered whether the anticipated expansion in bank credit was likely to reflect reintermediation for the most part, or whether some significant proportion would involve a net increase in total credit.

Mr. Axilrod replied that he had some difficulty with the meaning of the concept of reintermediation. Recently consumer-type time deposits had shown an unexpected surge. What was occurring, he thought, was a movement into such deposits--partly as a result of currently cautious attitudes--of funds that might otherwise have been invested in market instruments, such as equities, or gone into consumption. He would expect the rate of growth in total time deposits to taper off, partly because banks--after they had made their initial adjustment to the suspension of ceilings on short-term CD's--were likely to become less aggressive in seeking large negotiable CD funds from such investors as businesses and State and local governments. In addition, consumers were likely to reduce their rate of saving in the form of time deposits once the economy began to improve and uncertainties about the outlook decreased.

Mr. Hayes expressed the view that the Committee should not place undue emphasis on week-to-week fluctuations in the money supply, which had relatively little significance; rather, it should focus on the growth rate over a period of several months. He then observed that he was not sure that the possibility of a downward bias in the money supply statistics should be ignored completely in the conduct of open market operations. Admittedly, there were uncertainties in the matter, but he thought enough was known to justify giving at least marginal weight to the possibility of such a bias.

Chairman Burns said he would favor ruling out that consideration completely until such time as the staff was prepared to advise the Committee that there were reasonable grounds for indicating at least the direction of the bias.

Mr. Hickman remarked that if the Committee were to adopt a 6 per cent growth rate for money as its target but the public desired to expand its money holdings at, say, only a 4 per cent rate, the additional reserves supplied presumably would show up in the form of time deposits. In light of that possibility it was not clear to him that the Committee could rely on either money or bank credit for purposes of formulating policy.

Mr. Axilrod said he did not believe any one measure--money, bank credit, money market conditions, or whatever--could be taken as a certain guide for policy. While it was his opinion that in the period since the Committee had been giving increased weight to the

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money supply it had achieved better results than it had at times in the past, he did not think there was a close, direct connection between money supply and GNP. It was his view that a given growth rate for money served, in effect, as an index of policy and would be associated with particular credit and general liquidity conditions that in turn would affect GNP.

Mr. Partee remarked that if the Committee sought to make money expand more rapidly than the demand for money was growing--as Mr. Hickman had suggested might happen--interest rates presumably would decline and this would encourage a substitution by investors of time deposits for market instruments. He noted that interest rates on average had not in fact been moving down recently.

Mr. Hickman then said he thought it would be desirable at present for the Committee to give consideration to interest rates and conditions in securities markets as well as to the money supply--particularly in light of the probable volume of capital market financing over coming months and the need to foster a recovery in the housing industry.

Chairman Burns noted that there were different methods of measuring money supply growth rates for particular periods which apparently were of equal validity but which nevertheless could give different results. For example, as noted in the current blue book the monthly patterns for the third and fourth quarters associated with alternative A for the directive involved annual rates of growth of 5 per cent in both quarters, when the quarterly changes were

measured by comparing the levels in the final months of successive quarters. When measured by comparing the average levels for the full quarters, however, the growth rates were found to be 3.5 per cent in the third quarter and 4.5 per cent in the fourth.

Mr. Heflin asked whether the publication of the July wholesale price index had played any role in blunting the recent bond market rally.

Mr. Sternlight replied that the initial headlines indicating that the index had risen substantially might have had some effect on attitudes of market participants. However, whatever concern was created diminished when it became clear that the component for industrial commodities had increased only a little. Mr. Axilrod concurred in Mr. Sternlight's observation.

Mr. Coldwell said he agreed with Mr. Axilrod that the Committee had made some progress recently with respect to policy formulation. At the same time, he also agreed with earlier comments to the effect that the Committee should emphasize growth rates in the aggregates from quarter to quarter, rather than focusing on weekly or monthly changes.

Mr. Brimmer referred to a statement in the blue book indicating that, if the Federal funds rate were consistently around 6-1/2 per cent in coming weeks, "expectational factors could be generated which could increase bank and other investor demands for

debt obligations. This might lead to interest rate declines on a broader front...." He asked whether such a reduction in the Federal funds rate might not have the opposite effect of setting off interest rate advances, by persuading market participants that the System had given up in its efforts to control inflation.

Mr. Axilrod replied that he would expect such a result only if investors thought the economic outlook was quite strong.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period July 21 through August 17, 1970, were approved, ratified, and confirmed.

The Chairman then suggested that the Committee turn to a general discussion of the economic and financial situation and outlook.

Mr. Brimmer observed that he was deeply troubled by the rapid growth in bank credit that had occurred in recent weeks and that was projected for the period ahead. In his view a continued high rate of bank credit expansion might well regenerate expectations of further inflation. He thought that in making its policy recommendations today the staff had not given enough weight to the possible impact of the course it proposed on inflationary expectations.

Turning to the directive, Mr. Brimmer said that in his view the instructions the Committee had issued at the previous meeting

were subject to misinterpretation. He hoped the Committee would do better in formulating its instructions today.

Chairman Burns said he disagreed with Mr. Brimmer's comment on the directive. Indeed, he thought the instructions the Committee had issued at the previous meeting were clearer than any since he had become a member. They included three essential elements: First, primary attention was to be paid to the money supply rather than to bank credit. Second, the target path involved a 5 per cent rate of growth in money over the third quarter. And finally, if there was to be a deviation from the target path, it was the preference of a majority of the members that it be in an upward direction.

Mr. Mitchell said he sympathized with the view that the money supply alone was not a satisfactory guide to policy at this juncture. He agreed with the staff regarding the desirability of some increase in the growth rate for money, and he would be prepared to accept the 6 per cent rate recommended by Mr. Partee if it proved consistent with the other policy objectives he had in mind. However, he would not want to adopt such a growth rate in the second half of the year as a specific target for policy.

At present, Mr. Mitchell continued, he thought monetary policy should facilitate the necessary increases in residential construction activity and State and local government outlays by fostering expanded flows of funds to savings intermediaries and a

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gradual softening of long-term interest rates over the next several months. So long as those objectives were realized he would not be concerned about the particular rate of growth in the bank credit proxy. As to the directive, he favored revising the opening sentence of alternative B to read as follows: "To implement this policy, the Committee seeks to promote gradually easing conditions in credit markets and somewhat greater growth in money over the months ahead than occurred in the second quarter, while taking account of persisting liquidity problems and allowing bank credit growth to reflect a continued shift of credit flows from market to banking channels." He would interpret "gradually easing conditions" as calling for a Federal funds rate fluctuating around 6-1/2 per cent at the start.

Mr. Hayes indicated that his assessment of the outlook for real economic activity differed little from that presented by Mr. Partee today. However, he (Mr. Hayes) was rather confident that activity had already turned up and that the economy was no longer at dead center. He agreed that among the key expenditure sectors determining the pace of the expansion would be housing, State and local governments, and perhaps consumers. There also could be an important amount of stimulus from Federal spending, particularly if there were a Government pay raise early next year, and from the elimination of the inventory drag. He hoped the rate of expansion could be kept moderate and thought there was a reasonable prospect of doing so.

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Mr. Hayes observed that the stock market decline had had a considerable, and in his view favorable, impact on expectations and in particular on capital spending plans. However, the evidence of a slow-down in the rate of increase in prices was tenuous at best. He hoped that continuing productivity gains would dampen the rise in costs, but he found excessive wage demands and settlements to be a worrisome development. He agreed with Mr. Brimmer that the danger of reviving inflationary expectations was real and had to be taken into account by the Committee. While a sizable increase in bank credit in the last month or two had been appropriate, in view of the shrinkage in the commercial paper market following the Penn Central insolvency, he would be troubled by continued rapid bank credit growth now that the commercial paper market seemed to be stabilizing.

Mr. Coldwell said that the level of economic activity appeared to be on a plateau and was likely to remain on a plateau with perhaps some uptilt over the next few months. He thought that considerable imbalances were developing in the economy--including substantial wage-cost pressures and sizable unemployment--that might prove inimical to sustained growth later. If his assessment was correct, an upturn in activity was more likely than a recession, but the latter could not be ruled out. In those circumstances he would advocate a little stimulus from monetary policy but he felt such stimulus should be of modest proportions.

Mr. Heflin said he agreed with Mr. Hayes that the economy probably had bottomed out. The important question at the moment

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was how rapid the upswing would be. He was concerned that the economy currently was subject to the worst of two worlds--namely, rising prices and rising unemployment. He was in general agreement with the staff GNP projections for the remainder of the year, although he thought the projected level of unemployment might be too low. In that connection he noted the continuing additions to the labor force at a time when defense manpower needs were being cut back and businesses were holding down their labor requirements in a period of rapidly increasing wages and rising productivity.

On the other hand, Mr. Heflin continued, inflationary expectations had not died out as attention continued to be focused on inflationary wage settlements and rising price indicators. He agreed with Mr. Sternlight that the reaction to the July increase in the wholesale price index would have been much more pronounced if the rise in the industrial component of the index had not been moderate. It now appeared that inflationary expectations were tied more to recent and prospective wage settlements than to any feeling that demand was overly buoyant. However, he did not believe that the specific basis for the inflationary attitudes made any difference so far as borrower and lender incentives were concerned. Given that situation, he thought monetary policy should not get into a position of endorsing and validating cost-push inflation.

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Mr. Morris commented that he agreed with Mr. Mitchell on the need to focus on the level of housing and State and local government spending, given the prospective weakness in plant and equipment expenditures. It would be helpful if the staff could provide some guidance regarding the level of housing starts likely to be needed in 1971 to meet over-all economic objectives; that level might well be as high as 1.8 or 2.0 million starts. He had been impressed by the substantial rebound in starts in July--a rebound that occurred as a result of improvement in the availability of funds and despite continuing high interest rates. He thought the July experience suggested that the housing market had considerable vitality. In that connection he believed it would be a mistake for monetary policy to try to nudge long-term interest rates down. As the experience of 1967 indicated, interest rates would not remain at reduced levels unless investors became convinced that inflation had been brought under control.

Mr. Morris then said that as a member of the directive committee he was extremely pleased with the progress the Open Market Committee had made in that area. Also, he agreed with Chairman Burns that the directive issued at the previous meeting was the clearest thus far. The great advantage of directives of the recent type was that they left far less room than earlier directives for misunderstandings and disagreements regarding the

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nature of current policy. He thought the Desk and the staff were to be commended for the manner in which they had adapted to the new type of directive, and he personally would be unhappy if the Committee were to return to directives of the old type.

Mr. Francis commented that it had been popular to criticize stabilization actions and the performance of the economy over the past year. However, given the strong inflationary momentum gradually built up from 1964 through 1968, he believed that stabilization actions had, on the whole, been applied satisfactorily and that the economy had performed as well as could reasonably have been expected.

The rate of price increase had not been slowed much, if at all, Mr. Francis remarked. However, the rise had stopped accelerating, and all econometric models now indicated that a moderation of the upward price movement was likely this fall. Cutbacks in real output had been much less than in other periods when inflationary pressures were reduced. Unemployment had risen to 5 per cent of the labor force, but when spending was rising fast enough to keep the unemployment rate at about 4 per cent, strong upward pressure was exerted on prices and price expectations. In the period from 1962 through 1964 unemployment had averaged about 5-1/2 per cent of the labor force, and at the cyclical peak between the 1958 and 1960 recessions the unemployment rate had dropped no lower than 5 per cent.

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Mr. Francis said that much of the current unemployment was structural and could not be obviated except temporarily and with adverse price effects by stimulation of total spending. In view of the strong inflationary momentum, and the lags in the effects of monetary actions, quick results in obtaining relatively stable prices and a reduction of transitional unemployment should not be expected. Attempts directed at rapid cures or fine tuning had usually caused more serious problems later.

Mr. Maisel said he was somewhat surprised that Mr. Francis had raised the issue of structural unemployment in his remarks today. It was his belief that that question had been resolved some years ago, and he hoped the debate was not about to be renewed.

Mr. Maisel then observed that the staff's projections of real GNP had proved highly accurate in the past and he was willing to accept their latest projections as reasonable, given the underlying assumptions. If those projections were realized, however, the gap between actual and potential real GNP would be between 5.5 and 6 per cent by the second quarter of 1971. In his judgment, that was not satisfactory as a goal of policy. He also agreed with Mr. Mitchell on the necessity of stimulating an appropriate flow of funds to such key sectors as housing and State and local governments. Monetary policy was a better instrument than fiscal policy for closing the gap between actual and potential real GNP since it would also bring about these needed sectoral improvements, which would require a reduction in the level of interest rates.

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Referring to Mr. Morris' comment regarding long-term interest rates, Mr. Maisel said he would agree that efforts to nudge such rates down would be unsuccessful if their current levels were primarily a result of inflationary expectations. However, an interesting recent study suggested that prevailing high interest rates were related much more to a shortage of liquidity in the economy than to inflationary expectations of investors. That suggested to him that over the next year the Committee should seek to increase liquidity gradually, while observing the impact on interest rates as time went on.

Mr. Kimbrel remarked that his own reading of the economic statistics was perhaps slightly less bullish than that of the green book, but it was not contradictory to the view that the economy was leveling out or was already on the upswing. Nevertheless, if comments from his Sixth District contacts could be more generally applied, some adjustments in inventories still lay ahead. Moreover, there was a feeling held by quite a few of his contacts that the recovery in their own areas would be delayed and would be sluggish when it did come. He had heard from some of the retailers in the District that they expected sales for the rest of the year to rise only slightly. If that were true in the District and elsewhere, it would indicate that the consumer might not be ready to shoulder the burden of the recovery. That possibility was not reassuring to hopes for a booming economy.

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In fact, Mr. Kimbrel continued, he personally saw nothing in the current figures to indicate that the recovery would be rapid or that there would be a return to vigorous economic growth in the near future. Such a development, of course, would not be anything new. There had been periods of slow growth before, notably in the early 1960's. He did not think the possibility of a repeat performance could be ruled out, especially if the declining trend in defense spending continued. On the other hand, he would point out that in at least one important respect conditions were far different now. Instead of stable prices, one had yet to see a decline in either wholesale or consumer prices to normal levels. Under those circumstances, while he was persuaded that monetary policy should continue on a course of moderate ease, policy could not in his opinion afford to be overly easy at this time.

Mr. Daane recalled that at the previous meeting of the Committee he had been skeptical about the staff's view that consumer spending would rise enough to offset the shortfalls in capital spending, partly because he had thought the cutback in capital spending would be greater than indicated in the staff's projections. Today, he was prepared to accept the staff's new projection of capital spending but he remained unconvinced that consumers could be counted upon to spark and sustain an upturn in economic activity. It had been his impression on a recent trip to Michigan that attitudes were still

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being affected by the stock market decline and that people were concerned about rising prices. Against that background, he thought monetary policy should lean in the direction of providing for the greater availability of funds to which Mr. Mitchell had referred. He recognized the desirability of avoiding a policy sufficiently stimulative to rekindle inflationary expectations.

Mr. Daane said that while he would not favor an effort to force long-term interest rates down, he would not be unhappy if a reduction occurred as a result of monetary policy actions related to subsequent economic developments. And he thought the Desk should resist any upward pressures on long-term rates in the period ahead, when there would be a substantial volume of private offerings in the capital markets and a very large volume of Treasury financing.

Mr. Daane noted that earlier today he had suggested shifting from the present type of directive, focusing mainly on the money supply, to one with a primary instruction cast in terms of money market conditions and a proviso clause relating to money. While that remained his first preference, he would consider acceptable a directive along the lines Mr. Mitchell had proposed.

Mr. Melnicoff indicated that he viewed recent and prospective developments in the real economy very much as the staff did. However, he thought inflationary expectations were by no means dissipated and that an undue easing of policy might stimulate them and make it most difficult to bring inflation under control. He

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noted that Mr. Partee had suggested seeking a more substantial decline in interest rates and more rapid monetary expansion in order to make an economic recovery more certain, and that Mr. Axilrod had suggested that policy be more than usually generous in meeting the current large liquidity needs. He would note that any policy course that seemed to assure vigorous economic recovery, or to guarantee that all liquidity needs would be met, would at the same time run a serious risk of validating inflationary expectations.

Mr. Melnicoff said his policy recommendation at the moment was a pragmatic one--namely, to continue on the present course on the grounds that recent policy had been successful. He thought the Board's action yesterday in amending Regulation D had been well timed and well conceived. That action would serve as a good test of the current state of inflationary expectations, since it would be interpreted as representing some easing of monetary policy. His preference would be to observe the reactions of market interest rates before deciding whether to take any further easing action. Accordingly, he would prefer alternative A of the draft directives.

Mr. Hickman said that some decline in interest rates would seem desirable under current circumstances in order to assure an adequate flow of funds to the mortgage market, State and local governments, and corporations. He also thought that monetary policy

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should resist any backup in interest rates. In his view, a 5 per cent annual rate of growth in the money supply over the second half of the year was likely to be consistent with those objectives, whereas a 6 per cent growth rate might well prove overstimulative. The Committee had approved a 5 per cent target at its previous meeting and he felt that continuing efforts should be made to achieve it. Accordingly, his preference was for alternative A of the draft directives.

Mr. Mayo said he had found the analysis of the economic outlook presented by the staff today to be quite similar to that developed at the Chicago Bank. While he personally did not consider the economy to be on "dead center," he did think it was still sluggish. There were some signs of an upturn, although the more definitive signs for which people were carefully watching had not yet materialized. He shared Mr. Morris' view regarding the importance of housing in the economic outlook, but he feared that the recent bulge in housing starts might be short-lived unless there was some further moderation in long-term interest rates. He did not think monetary policy should try to force interest rates down, but he felt policy could have some marginal influence in that direction.

Mr. Mayo indicated that he was philosophically inclined toward Mr. Daane's proposal for the directive because he also had

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reservations about an unduly narrow focus on the monetary aggregates. However, he thought that since the increased emphasis on the money supply in recent directives seemed to have proved useful, he was not prepared to endorse Mr. Daane's proposal at this time. He did believe that it would be desirable to include a reference to the objective of easing credit conditions, as Mr. Mitchell had suggested. He remained concerned about inflationary pressures in the economy, but thought that economic activity was sufficiently sluggish to warrant a 6 rather than a 5 per cent target growth rate for the money supply.

Mr. Swan observed that there appeared to be much less concern now than a few months ago about a cumulative downtrend in economic activity. However, there also seemed to be increased acceptance of the view that the upturn would be more gradual than thought earlier. Those changes in expectations were a desirable development, he thought.

Mr. Swan said that, like others, he was disappointed by the lack of substantial progress in curbing rapid wage and price advances and was concerned about the risk of feeding inflationary pressures by fostering overly rapid expansion in the monetary aggregates. He would have no objection to reaffirming the 5 per cent target rate for growth of money that was agreed upon at the previous meeting, but he believed that a faster rate of expansion might carry grave implications.

Mr. Swan noted that the flow of funds, particularly to bank and nonbank thrift institutions, had improved in recent weeks. Although he could not cite firm evidence, it was his impression that the availability of credit had increased at Twelfth District banks. Savings and loan associations had experienced sizable inflows of funds in July, and in California the inflows in August were likely to prove relatively good despite the recent Treasury financing. Those developments were of the kind that were needed now, and he would not want the System to do anything at this point that might tend to reverse them.

Mr. Robertson made the following statement:

I believe that current monetary policy is about on track. As I see it, the task of this Committee continues to be that of treading the very narrow way between providing too much and too little stimulation to the economy. For instance, if our policy permits an annual rate of growth in money supply much in excess of 5 per cent over a longish period, and if the rate of bank credit expansion does not begin to slow down from its recent unusually rapid pace, I foresee dangerous and excessive stimulation which will negate all we have been trying to achieve and bring back the kind of inflationary psychology we were facing earlier. The rate of increase in over-all prices is still too high for the nation's welfare, despite emerging areas of some price softness. Over-all price increases still seem to be stimulating inflationary settlements in collective bargaining, as judged by the data for the second quarter of this year which reflected the construction and trucking industry settlements. And we have ahead of us important wage contract negotiations in the manufacturing areas, with auto worker contracts expiring in mid-September.

While current wage and price developments are not particularly heartening, we do finally appear to be

seeing a significant improvement in productivity in the nonfarm private economy as a whole and an associated sharp reduction in the rate of increase in unit labor costs. This should work toward moderating upward price pressures. Of course, this gain in productivity has been partly at the cost of reduced employment and working hours. And this, in turn, reflects the reduction we have seen in real demand for goods and services, principally as a result of declining defense outlays, the ending of the capital goods boom, and weakness in the residential construction area.

It would not be desirable in my opinion to seek to secure further productivity gains at the expense of employment opportunities and our policy should be designed to avoid such a development--which means, for the near future, a growth in monetary aggregates which might be typified by about a 5 per cent growth rate for money.

The Board's reserve requirement action, modest as it was, should be considered as an element, but only as an element, in such a monetary policy; i.e., as an aid in maintaining such a growth rate in monetary aggregates. However, depending upon how it is interpreted by the public, it may serve to bring about slightly easier credit conditions sooner in the important mortgage and State and local government security markets--and this will be an aid in sustaining aggregate demand and employment.

In order to help achieve this objective, I hope the Manager will not endeavor to prevent the Federal funds rate from declining some, or net borrowed reserves from diminishing somewhat. However, I would not want to see him seek a sharp drop in the Federal funds rate because I would not want to see any magnification of the announcement effects of our reserve requirement action. Rather, I would hope our action would be considered as an attempt to clear up the status of bank-related commercial paper while avoiding any significant change in our over-all policy.

Alternative A of the directive drafts seems to mesh with these views and therefore I would vote for it in preference to alternative B.

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Mr. Sherrill said he thought the economy was in a period of hesitation and could go either way. It was his impression that the business community was making increasingly conservative decisions which might well lead to a decline in economic activity, particularly if business psychology were to be further depressed by the failure of some important firms. He thought that monetary policy should be sufficiently stimulative to insure against the risk of a serious downturn in economic activity and to foster a recovery. At the same time, he would not want policy to become overly stimulative.

Mr. Clay remarked that he did not think a change in monetary policy, or in its emphasis, was desirable at this time. The Committee had to pursue further the narrow path between too much restraint and too much stimulus in order to reach the long-term goal of orderly economic growth with stability in prices. Considering the length and intensity of the inflationary boom, the adjustment had been relatively moderate. There did not appear to be evidence of the development of a cumulative downturn. On the other hand, aggregate activity appeared to have bottomed out and was showing some indication of a slight upturn. There was some evidence of lessening of inflationary price pressures, but that problem was responding slowly and would require a considerable period for the necessary adjustment. The wage-cost aspect continued to be particularly troublesome.

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It seemed to Mr. Clay that monetary policy had done its part rather well during 1970 with respect to both financial and nonfinancial developments. Moderate growth in financial aggregates should continue to be the policy goal. It would require patience to avoid taking a more stimulative posture, but moderation was necessary in order to avoid an intensification of the price inflation problem. Recognition also had to be given to the fact that Federal fiscal policy was becoming increasingly expansive.

Mr. Clay said the bank credit and money supply figures were difficult to interpret at this moment. Bank credit growth was running much higher since the modification of Regulation Q, and involved a substantial shift of credit from market to banking channels. The Committee needed to be alert to the possibility that a significant portion of the bank credit growth might not involve such a shift, however. Some part of the growth might arise from a restructuring of deposits from demand to time accounts. To the extent that that situation prevailed, money supply growth was muted and that fact needed to be taken into account in setting the money supply targets. He thought both bank credit and money supply developments should be watched closely in the period ahead.

Mr. Galusha said he viewed as realistic the paths for various economic variables projected by the staff on the assumption of a 5 per cent growth rate in the money supply, except for prices;

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he suspected that the problem of cost-push inflation would prove to be much more intractable than implied by the projections. But there was little that monetary policy could do to alter that situation.

While the projections might otherwise be realistic, Mr. Galusha continued, he agreed with Mr. Maisel that they did not represent appropriate goals for the Committee. In particular, looking toward the second quarter of 1971, he thought the projected level of unemployment--5.7 per cent--was too high to be taken as a national objective, and the projected growth rate in real GNP--3.3 per cent--was too low.

In his judgment, Mr. Galusha observed, the appropriate course for policy at this time would be intermediate to the courses associated with directive alternatives A and B. Thus, he thought the target for the money supply should be growth at a rate somewhere between 5 and 6 per cent. Over the period until the next meeting, the 3-month Treasury bill rate might most often appear in the 6 to 6.25 per cent interval; member bank borrowings would average closer to \$800 million and net borrowed reserves closer to \$700 million; and the Federal funds rate would most often be at or below 6.50 per cent. He thought those specifications might be similar to those Mr. Daane had in mind, but he was not sure.

Mr. Daane said he would prefer a lower net borrowed reserve figure.

Chairman Burns said he hoped those who thought the economy had turned up were correct, but he did not believe such a conclusion was justified by the available evidence. It seemed to him that the recent configuration of many economic factors--including labor market conditions, corporate profits, new orders for plant and equipment, and the rate of formation of new businesses--was not consistent with the patterns that had been associated with economic recoveries in the past.

At the same time, Chairman Burns continued, he thought great progress had been made in checking and changing inflationary psychology. In his judgment too much attention was being paid to the price indexes and not enough to the impressive body of evidence revealing a change in attitudes. For one thing, businesses had become highly cost-conscious in recent months, and the cost-cutting process had already gone much further than many people realized. For example, manufacturers had been making sizable cutbacks in employment not only of production workers, but also of office staffs. Thus, employment of nonproduction workers in manufacturing had been reduced significantly in each of the five months through July. That was a dramatic new development; in the comparable months of the 1960-61 recession nonproduction worker employment had continued to expand in every month but one.

A second indication of the change in attitudes was the downward revisions being made in capital spending plans, the

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Chairman remarked. Those cutbacks were still in their early stages and would probably continue for a period of at least nine to twelve months. Given the present cost-consciousness of the business community, a prompt revival of capital expenditures appeared to be extremely unlikely.

A third piece of evidence, Chairman Burns said, was the heightened quality-consciousness of investors that Mr. Axilrod had mentioned. In the market for corporate bonds, for example, offerings of the highest grade were being taken up readily at declining rates while those of companies of lesser reputation were encountering some difficulty. That was demonstrated by the spread between yields on Aaa and Baa bonds--one of the most sensitive and useful measures of sentiment in financial markets. Before the Penn Central insolvency, that spread had been fluctuating in a range of 70 to 80 basis points. Subsequently it increased week by week, most recently reaching a level of 132 basis points.

Also, the Chairman continued, he understood that while bankers were anxious to accommodate the demands of their best customers, they were considering loan applications from others more searchingly than earlier. And consumers had become quite cautious in their spending behavior; they were avoiding luxury goods and seeking out lower quality items. That was indicated by recent increases in the proportion of total new car sales

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accounted for by small cars, domestic and foreign; by the sales performance of black-and-white television sets relative to color, and of small TV's relative to large; and by the size of the price reductions merchants were having to make to dispose of last year's models of various durable goods.

Chairman Burns went on to say that, if he was right in his judgment that psychology had changed drastically in recent months, there would be much less risk now than earlier in some easing of credit conditions. That was the direction in which he thought the Committee should move; he was inclined toward some version of alternative B today. He held that preference not because he was dissatisfied with the objective for the money supply the Committee had agreed upon at the last meeting, but because that objective had not been fulfilled.

The Chairman then remarked that it might be desirable, before any particular directive was put to a vote, to determine the sentiment of the Committee with respect to the positions implied by the successive clauses of the modified version of alternative B proposed by Mr. Mitchell. He asked the members to indicate first whether they would like to see gradually easing conditions in credit markets, and seven members responded affirmatively.

Mr. Coldwell observed that he would prefer to have the objective formulated in terms of "slightly easier conditions" in

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credit markets, since "gradually easing conditions" seemed to imply a commitment to a continuing move.

Chairman Burns remarked that the distinction was more than a semantic one. In his opinion there was much to be said for seeking a gradual easing. Prevailing levels of interest rates and member bank borrowings were extraordinarily high by historical standards, and if the present degree of tightness continued for much longer he thought a serious problem would arise in connection with residential construction. There was a pent-up demand for housing, mortgage funds were becoming available on a scale that was thought hardly likely only a few months ago, and building activity was responding. But that adjustment might prove short-lived; with interest rates at their present levels and with construction costs rising, a large proportion of middle-income families could not afford to buy houses. Thus, he thought a gradual easing of credit market conditions would be desirable. If pursuit of that objective was found to be stimulating inflationary sentiment, or if the economic situation changed substantially in other ways, the Committee could modify its goals; to his mind there would be no implied commitment with respect to future policy.

Mr. Francis said that from conversations with officials of savings and loan associations and suburban banks in his District

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he had concluded that inflated costs, rather than high interest rates, were the major impediment to home buying.

With respect to the positions implied by other clauses in Mr. Mitchell's proposed directive, it was determined that the Committee members were unanimous, or nearly so, in their desire (a) to see somewhat greater growth in money over the months ahead than occurred in the second quarter, when growth was at an annual rate of 4.2 per cent; (b) to take account of persisting liquidity problems; and (c) to allow bank credit growth to reflect a continued shift of credit flows from market to banking channels. In expressing their views, individual members offered certain qualifications regarding language. Thus, it was suggested that in light of the recent abatement of liquidity pressures it was more accurate to speak of "possible" rather than "persisting" liquidity problems; and that in view of the uncertainties regarding shifts of credit flows from market to banking channels, it was better to refer to "any" rather than to "a" continued shift of that kind.

The Chairman then suggested that the Committee consider the target growth rate for the money supply. As he had noted earlier, for the next four weeks there was very little difference in the growth paths associated with alternatives A and B. For the longer run, however, the former called for growth at a 5 per cent annual rate and the latter for growth at a 6 per cent rate.

After discussion, Chairman Burns remarked that the Committee might again want to adopt a 5 per cent annual rate of growth as its target for money, on the understanding that if there were any deviations from that target rate the preference was that they be in an upward rather than a downward direction. It was determined that most members favored a 5 per cent target with such an understanding.

The Chairman then proposed that the members indicate their preferences between two alternatives for the second paragraph of the directive: alternative A, as shown in the staff drafts; and the version of alternative B proposed by Mr. Mitchell, with two language modifications that had been suggested--to refer to "possible" liquidity problems and to "any" shift of credit flows from market to banking channels.

Mr. Maisel remarked that Committee agreement on the wording of the directive would still not resolve the question of the specific operating instructions to be given to the Desk. He thought the Committee should choose between the money market conditions associated with alternatives A and B in the blue book.<sup>1/</sup> His own preference was for the alternative B conditions.

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<sup>1/</sup> The blue book statement regarding money market conditions in connection with alternative A read as follows: "Achievement of a 5 per cent money supply growth might require a Federal funds rate generally around 6-1/2 - 6-3/4 per cent, member bank borrowings dropped to an average of around \$800 - \$900 million, and net borrowed reserves in a \$700 - \$800 million range. Such a set of (continued on next page)

Mr. Hickman expressed a preference for the conditions associated with alternative A.

Mr. Mitchell noted that the directive language he had proposed called for gradually easing credit conditions.

Chairman Burns commented that as he understood the Committee's wishes the degree of easing to be sought would be that which appeared best calculated to result in a 5 per cent growth rate for the money supply, with any deviations on the high rather than the low side.

It was determined that six members (Messrs. Hayes, Brimmer, Francis, Hickman, Robertson, and Swan) preferred alternative A, and six (Messrs. Burns, Daane, Heflin, Maisel, Mitchell, and Sherrill) preferred the modified version of Mr. Mitchell's proposal.

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(continued from preceding page) money market conditions might be accompanied by some decline of interest rates in short-term credit markets in consequence of greater provision of nonborrowed reserves by the System. The 3-month bill rate would probably decline in a 6-1/8 - 6-1/2 per cent range."

The corresponding statement in connection with alternative B read as follows: "Encouragement of the more rapid growth in the money supply indicated above would entail a more generous provision of nonborrowed reserves by the System. As a result, net borrowed reserves would likely move into a \$500 - \$700 million range, member bank borrowings drop to \$650 - \$800 million, and the Federal funds rate might generally be in a 6 - 6-1/2 per cent range. A relatively sharp drop in Treasury bill rates, as well as other short-term rates, probably would accompany such an easing in the money market, particularly if the Federal funds rate moves down close to the discount rate and engenders expectations of a discount rate reduction. It is not improbable that the 3-month Treasury bill rate would drop below 6 per cent under those circumstances."

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It was suggested that the two alternatives again be put to the Committee after certain additional modifications had been made in each. The modification in alternative A was to substitute "moderately greater growth" for "moderate growth" in the statement that "the Committee seeks to promote moderate growth in money over the months ahead." The modification in the other alternative was to substitute "some easing of" for "gradually easing" in the statement that "the Committee seeks to promote gradually easing conditions in credit markets." It was found that no member had shifted his preference from one alternative to the other as a result of those modifications.

The Chairman then noted that while the Committee's preferences were evenly divided between the two alternatives, a majority had concurred in the substance of each of the successive clauses of the language Mr. Mitchell had proposed. He suggested that the Committee vote the latest version of that alternative up or down.

Questions were raised as to whether, in the interest of clarity, certain language changes might be desirable in the proposed second paragraph and also in the staff's draft of the first paragraph. It was agreed that in view of the lateness of the hour the resolution of those questions should be left to the judgment of the Chairman, in consultation with the staff.

Mr. Sternlight said he would like to raise a question about operating strategy if the Committee should adopt the directive language proposed. If after some easing of credit conditions it

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appeared that the money supply was expanding on a path consistent with growth over the longer run at an annual rate of 6 or 7 per cent, should priority be given to the objective of easier credit conditions or to the money supply target? In other words, should the Desk back off from the degree of ease initially achieved under the directive?

Mr. Mitchell expressed the view that no harm would be done by money supply growth at a 6 or 7 per cent rate during the brief period until the next meeting of the Committee. Accordingly, he would not favor backing off under such circumstances.

Chairman Burns said he would not be disturbed by an overshoot, particularly in light of the earlier undershoot. He would not necessarily have the same view if the growth rate was higher than that Mr. Sternlight had mentioned or was tending to stay high for a sustained period.

Messrs. Hayes, Brimmer, and Francis indicated that they planned to dissent from the proposed directive. Mr. Hayes said he would like to submit for the record certain remarks on monetary policy which he had prepared but had not had an opportunity to deliver. It was his hope that in future meetings the Committee would resume its earlier practice of having a "go-around," in which the members commented in turn on policy and the directive, before the Committee voted on a directive.

Chairman Burns remarked that that procedure would have been followed today had time permitted. He invited members who so desired to submit statements on policy for the record.

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

The information reviewed at this meeting suggests that real economic activity, which edged up slightly in the second quarter after declining appreciably earlier in the year, may be expanding somewhat further. Prices and wage rates generally are continuing to rise at a rapid pace. However, improvements in productivity appear to be slowing the rise in costs, and some major price measures are showing moderating tendencies. Credit demands in securities markets have continued heavy, and interest rates have shown mixed changes since mid-July after declining considerably in preceding weeks. Some uncertainties persist in financial markets, particularly in connection with market instruments of less than prime grade. In July the money supply rose moderately on average and bank credit expanded substantially. Banks increased holdings of securities and loans to finance companies, some of which were experiencing difficulty in refinancing maturing commercial paper. Banks sharply expanded their outstanding large-denomination CD's of short maturity, for which rate ceilings had been suspended in late June, and both banks and nonbank thrift institutions experienced large net inflows of consumer-type time and savings funds. The over-all balance of payments remained in heavy deficit in the second quarter, despite a sizable increase in the export surplus. In July the official settlements deficit continued large, but there apparently was a marked shrinkage in the liquidity deficit. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and somewhat greater growth in money over the months ahead than occurred in the second quarter, while taking account of possible liquidity problems and allowing bank credit

growth to reflect any continued shift of credit flows from market to banking channels. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective, taking account of the effects of other monetary policy actions.

Mr. Hayes' statement on policy read as follows:

It seems to me that the proper role for monetary policy in the current setting is to continue to encourage the resumption of moderate real economic growth--and I would stress "moderate"--over the next four quarters. The probability that such moderate growth will be accompanied by some further increase in the unemployment rate should not deter us, although naturally we must keep an eye on the extent to which unemployment may worsen. There is good reason to expect that the rate of inflation will gradually diminish over the coming year if the economy develops along the lines we now consider most likely. Probably the biggest achievement arising from our past efforts has been the marked check to inflationary psychology which has occurred over the past two months particularly. While that period's disturbing financial developments could not be considered desirable in themselves, they have certainly contributed importantly to this change of sentiment. At this juncture it would be most unfortunate if an overt easing move by the System were to revive some of the inflationary expectations that have been effectively dampened. It is clear, especially in view of the continuing excessive wage demands and settlements, that the inflationary virus in the economy is still very dangerous. And apart from domestic considerations, the danger is pointed up by our unsatisfactory balance of payments position, and by growing uneasiness abroad about the dollar, based in good part on fears that the United States may give up the anti-inflationary fight before it has been won. Furthermore, the prospect of a Treasury deficit which our staff now estimates at close to \$12 billion for fiscal 1971 suggests that considerable stimulus will come from fiscal developments.

Like other members of the Committee I too have been disappointed that the growth of the money supply has recently been running somewhat below our target.

I would hope that open market operations would be aimed at encouraging a growth rate of about 5 per cent. This should be compatible with a Federal funds rate a shade under 7 per cent, and a net borrowed reserve position in the range of \$600 to \$800 million, assuming that special borrowing at the discount window associated with stresses in the commercial paper market continues to decline. However, if the money supply growth rate continues to fall short of our 5 per cent target, I believe somewhat easier money market conditions and a lower range for the funds rate--say around 6-1/2--might prove necessary. It goes without saying that we should try hard to get to the bottom of the statistical problem with respect to the money supply referred to in the blue book. Meanwhile, we should not lose sight of bank credit growth, and here I would hope that the rate would moderate from its recent very high level in view of the indications that total outstanding commercial paper is no longer shrinking significantly.

As I have already indicated, I would oppose an overt move of ease at this point. I am glad that yesterday's move, which struck me as highly constructive, was modest in amount and was not presented as a significant easing action. The added burden on the New York banks seems small enough to be handled without great difficulty. I might add that at some juncture over the coming months I would like to see the suspension of Regulation Q ceilings applied to CD's maturing beyond 90 days.

As for the directive, I would like to see a minor change in the opening sentence of the staff's draft, to make it read "real economic activity...appears to be expanding further" rather than "may be expanding somewhat further." Also, I would suggest eliminating the clause "and some major price measures are showing moderating tendencies" from the third sentence. Alternative A for the second paragraph seems about right, although I would insert the word "possible" before "continued shift of credit flows from market to banking channels."

Mr. Brimmer submitted the following statement for the record:

As I read the unfolding evidence, the performance of the American economy is quite mixed. However, on balance, it appears that a cumulative downturn in real

economic activity is not likely. Rather a modest expansion in output during the remainder of 1970 and into 1971 seems the more likely prospect. Consumer and residential construction outlays are likely to be stronger while business fixed investment will probably be weaker than had been expected. Thus, the plant and equipment boom--which has been a main source of inflationary pressure in recent years--appears to be waning rapidly.

Nevertheless, despite the progress we have made in reducing excess demand in the economy, we have made little actual headway against inflation. Prices are still rising at an unacceptably rapid rate. For example, in the second quarter the implicit GNP deflator rose at an annual rate of 4.2 per cent, compared with about 5.5 per cent in the first quarter (after allowing for the Federal pay increase) and 4.7 per cent for all of last year. In the current and following quarters, further modest easing in the rate of inflation will probably occur, but by year-end the GNP deflator may still be rising at an annual rate of about 3-1/2 per cent. Thus, the battle to check inflation in the United States remains to be won.

Under the circumstances, the proper objective for monetary policy should continue to be the fostering of modest growth in bank credit. The aim should be to provide a modest increase in the liquidity of the economy without stimulating renewed inflationary pressures. Consequently, we should be careful to avoid such an expansion in the availability of bank credit that expectations of renewed inflation will be rekindled.

Mr. Francis submitted the following statement for the record:

Pursuing money market goals, particularly during periods of even keel constraint, has continued to cause problems of managing the monetary aggregates. From February to May money rose rapidly, but since mid-May it has risen little. In view of the desire of this Committee to maintain a moderate growth of monetary aggregates, this uneven performance has been disappointing. Even if the economic impact of our actions since the beginning of 1970 has been nearly the same as that of a more steady monetary growth,

it is unwise, I believe, to control money so loosely. Unless monetary aggregates are moving as desired within periods of less than five or six months, we have no assurance of adequate control.

Our directives so far this year have been calling for moderate growth in both bank credit and money. In the past two months, bank credit has risen sharply while the money stock has changed little. This Committee needs to decide now which of the two aggregates is to be followed or how the two are to be weighted. The rapid growth in bank credit reflects primarily a sizable reintermediation of funds which formerly flowed through other avenues, and not an addition to total credit. Hence, bank credit may now be misleading as a proximate guide, and I suggest that actions be taken to foster a moderate growth in the money supply.

Over the past year and a half, money has risen at an average 3 per cent annual rate. Since the beginning of this year growth has been at a faster 4 per cent average rate. I believe that money should continue to expand at a moderate rate in the near future. The 4 to 5 per cent trend rate of alternative A seems appropriate. It would be desirable, in my opinion, if growth in money were steadier than it has been in the past year, even if this results in more variability of interest rates and other market conditions.

According to estimates of the St. Louis Bank, if money expands at a fairly steady 4 to 5 per cent pace, total spending would rise slightly faster than the growth in productive capacity and price increases would gradually moderate from the 5.3 per cent rate in the first half of 1970 to about a 4 per cent rate in late 1971. Real output, according to these estimates, would rise only slightly in late 1970, but would increase at about a 3.5 per cent annual rate in the last half of next year.

Mr. Maisel submitted the following statement for the record:

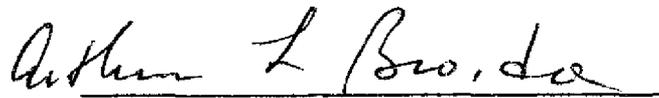
Alternative B of the staff draft directives is in my view an appropriate directive for the interval until the next meeting of the Committee. Alternative B properly focuses on growth in money ( $M_1$ ). Much of the Committee's discussion at recent meetings was concerned with the risk of unduly rapid growth in money, as a consequence of a temporary reversion to greater emphasis on money market conditions. Fortunately, the latest directive was written in symmetrical terms that allowed

the Desk to adapt operations to a shortfall from the desired growth of money. This experience illustrates the problems that would be involved in a return to an old-style directive stated in terms of money market conditions.

In the current situation, the impact of yesterday's Regulation D action by the Board, including the reactions of dealers and banks, is unknown as yet. The dealers have large inventories and the odds are that they will not increase them further. Thus, the impact will probably be largely on expectations. There seems to be little reason for concern but one cannot be sure. The uncertainty regarding those reactions is an argument in favor of adopting alternative B. That alternative calls for an easing of credit market conditions, but it also gives the Manager some guidance as to what to do if there are unexpected developments. He need not fight lower interest rates if the aggregates are in line, but he would react if there is a change in expectations and a large spurt in money. This I think is the proper approach. We should meet liquidity needs at a more rapid rate but should not get carried away. Alternative B, as written, would protect us against the latter possibility.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, September 15, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.

  
Deputy Secretary

ATTACHMENT A

August 17, 1970

Drafts of Current Economic Policy Directive for Consideration by the  
Federal Open Market Committee at its Meeting on August 18, 1970

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real economic activity, which edged up slightly in the second quarter after declining appreciably earlier in the year, may be expanding somewhat further. Prices and wage rates generally are continuing to rise at a rapid pace. However, improvements in productivity appear to be slowing the rise in costs, and some major price measures are showing moderating tendencies. Credit demands in securities markets have continued heavy, and interest rates have shown mixed changes since mid-July after declining considerably in preceding weeks. Some uncertainties persist in financial markets, particularly in connection with market instruments of less than prime grade. In July the money supply rose moderately on average and bank credit expanded substantially. Banks increased holdings of securities and loans to finance companies, some of which were experiencing difficulty in refinancing maturing commercial paper. Banks sharply expanded their outstanding large-denomination CD's of short maturity, for which rate ceilings had been suspended in late June, and both banks and nonbank thrift institutions experienced large net inflows of consumer-type time and savings funds. The over-all balance of payments remained in heavy deficit in the second quarter, despite a sizable increase in the export surplus. In July the official settlements deficit continued large, but there apparently was a marked shrinkage in the liquidity deficit. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee seeks to promote moderate growth in money over the months ahead, while taking account of persisting liquidity problems and allowing bank credit growth to reflect a continued shift of credit flows from market to banking channels. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective, taking account of the effects of other monetary policy action.

Alternative B

To implement this policy, the Committee seeks to promote somewhat greater growth in money over the months ahead, while taking account of persisting liquidity problems and allowing bank credit growth to reflect a continued shift of credit flows from market to banking channels. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective, taking account of the effects of other monetary policy action.