MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, July 21, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Heflin
Mr. Hickman
Mr. Maisel
Mr. Robertson
Mr. Sherrill
Mr. Swan
Mr. Treiber, Alternate for Mr. Hayes

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Garvy, Gramley, Hersey, Hocter, Jones, and Reynolds, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Bernard, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors
Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Kèir, Associate Adviser, Division of Research and Statistics, Board of Governors

Mr. Baker, Economist, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors

Mr. Baughman, First Vice President, Federal Reserve Bank of Chicago
Messrs. Eisenmenger and Taylor, Senior Vice Presidents, Federal Reserve Banks of Boston and Atlanta, respectively
Messrs. Bodner, Snellings, Scheld, Billington, and Green, Vice Presidents, Federal Reserve Banks of New York, Richmond, Chicago, Kansas City, and Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Mr. Lynn, Director of Research, Federal Reserve Bank of San Francisco
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on June 23, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on June 23, 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 June 23 through July 15, 1970, and a supplemental report covering the period July 16 through 20, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner observed that the general tone of the exchange markets in the past month had continued to be very much as described by Mr. Coombs at the last meeting of the Committee. The nervousness and, indeed, pessimism of the exchange markets regarding the relative levels of major exchange rates and the possibility of significant changes in exchange practices surfaced during the course of the meetings of the Group of Ten deputies in Paris the week before last. With reports of an important new U. S. initiative toward greater exchange rate flexibility, several currencies moved in the directions the market anticipated they would if allowed such flexibility. In particular, sterling weakened and the German mark and the Swiss franc strengthened.

Exchange rate uncertainty, of course, was not the only factor operating in the markets, Mr. Bodner said. Throughout the period there had been significant flows of funds out of sterling and into marks through Euro-dollars as a result of the pattern of interest rates prevailing in these markets. The slight relaxation of monetary policy in Germany last week, coupled with the easing of pressures in the Euro-dollar market, had reduced the drain on sterling and helped to produce a somewhat calmer over-all atmosphere in recent days.

Mr. Bodner reported that sterling had continued its steady decline from its April highs and currently was trading around $2.3880. The disparity in interest rate levels between the United Kingdom and

the Euro-dollar market was the main source of pressure on sterling during the period, and in early July the Bank of England had to step into the market and provide about $125 million in support. Otherwise, however, the retreat had been orderly. In fact, given the poor trade figures released during the month and the outbreak of a major dock strike, sterling had held up remarkably well, with no intervention since July 7. The over-all atmosphere, however, was very pessimistic, as indeed it had been all along. Most traders had always felt that the buoyancy of sterling would not last past the spring and the current pessimism came as no surprise. Clearly, for the future very much was going to depend on how quickly the present dock strike was settled, the means by which it was settled, and the terms agreed upon. A prolonged strike certainly would put increased pressure on sterling, and the Bank of England was running out of room in which to let the rate take the pressure; at some point fairly soon additional reserves would have to be used. The Account Management had already been approached by the Bank of England regarding a possible swap drawing this month and there might well be further need before the month was out.

The other major weak spot in the system was the Italian lira, Mr. Bodner continued. Pressure on the lira had continued to drain Italian reserves and losses so far this month totaled $370 million. Continued deterioration in the Italian current account as a result of widespread strikes, coupled with the ongoing political crises, had resulted in an increasing chorus of devaluation rumors. The fact that

the Italians had drawn down their reserve position in the Fund, while certainly a desirable move in itself, had intensified the concern about the lira. While Italy's over-all reserve position remained relatively strong, the summer inflow had not materialized as anticipated and the situation looked, if anything, more serious than it had a month ago.

Mr. Bodner remarked that the other side of the coin was represented by the mark, Swiss franc, Belgian franc, and guilder, all of which had been very strong; the Germans in particular had pulled in large amounts of money through early July. In fact, these German reserve gains--some $700 million spot and $275 million forward--were not far behind those of June. Once again there had been talk of another revaluation or a temporary floating of the mark. In the last few days a lot of that talk had died down following the new fiscal policy steps by the German Government and some easing of monetary policy through a cut in the discount and Lombard rates. More generally, it seemed to him that the German situation, while it had been uncomfortable for a few months, was likely to improve. The spot rate had been away from the ceiling since the early part of this month and the over-all German payments position seemed to be moving into better balance as the effects of revaluation worked their way through the economy.

Mr. Bodner observed that both the Belgian franc and the Dutch guilder had remained strong during this period, in part because

of money market pressures and in part because of speculative exchange flows. In the case of Belgium, the System had had to activate the swap line and now had $50 million of drawings outstanding. In the case of the Netherlands, a large inflow of dollars last week pushed the dollar position of the Netherlands Bank beyond the upper end of the range that they were prepared to hold and, consequently, the Dutch would be buying $20 million of gold from the U. S. Treasury this week. A request for a swap drawing in the near future was a distinct possibility, since it seemed likely that there would be further inflows to the Netherlands during the next few days.

Mr. Bodner remarked that through all of the uncertainties in the exchange markets in the last month the Canadian dollar had floated fairly peacefully. Although the nervousness generated by the Canadian move had had effects on other currencies, and had significantly disturbed the markets, the Canadian rate itself had remained in a very narrow range, with no large flows of funds and with only very minor intervention by the Bank of Canada.

All in all, Mr. Bodner said, the exchange market picture, although somewhat calmer in the last few days, was not a very attractive one. In the middle, of course, was the U. S. dollar with this country's own enormous balance of payments deficit and continuing inflation causing increasing concern abroad. Despite that picture of almost unrelieved gloom, however, he did not think there would be a major crisis in the very near future, at least so long as the

domestic financial markets continued to weather the present storms. That, it seemed to him, was crucial; major disturbances in U. S. financial markets--and, in particular, any feeling that the situation was getting out of control--could have the gravest implications for the exchange markets. The present obviously was a very difficult period, but it seemed to him that there were no fundamental reasons why the problems could not be handled satisfactorily. The underlying balance of payments disequilibria that had created past upheavals had been very largely removed by the parity adjustments that had already occurred. With perhaps one or two minor exceptions, there was no reason to think that the basic exchange rate relationships now prevailing involved any major misalignments. It should, therefore, be possible to defend them against any serious disturbances. The principal requirements were that the U. S. authorities deal with their own domestic problems and that both they and their foreign colleagues keep cool heads.

By unanimous vote, the System open market transactions in foreign currencies during the period June 23 through July 20, 1970, were approved, ratified, and confirmed.

Mr. Bodner then noted that a $185 million System swap drawing on the Swiss National Bank would mature for the first time on August 14, 1970. As things stood now, it was anticipated that that drawing would be liquidated at maturity; the Swiss National Bank had indicated that it would be prepared to add to its dollar position

at the maturity of the drawing if it could convert $50 million into gold, and the U. S. Treasury had agreed to that gold purchase. Given the existing uncertainties, however, there was always a possibility of new inflows into Switzerland that would make it impossible to proceed with that plan. Accordingly, he would recommend renewal of the drawing if that should prove necessary.

> Possible renewal of the $185 million System swap drawing on the Swiss National Bank was noted without objection.

The Chairman then invited Mr. Daane to report on his recent trip to Europe.

Mr. Daane noted that along with Mr. Coombs he had attended the monthly meeting of central bank governors in Basle during the weekend of July 4. Despite the uncertainties in exchange markets to which Mr. Bodner had referred, the discussion was rather quiet. Most of the principal points of interest raised during the governors' go-around in the afternoon session related to matters on which Mr. Bodner had commented today. The Governor of the Bank of England expressed concern about the outflows of funds from Britain resulting from unfavorable interest rate differentials. Remarks by the President of the German Federal Bank foreshadowed the subsequent reductions in that Bank's discount and Lombard rates--and also the temporary increase in taxes in Germany and the rescinding of the investment tax credit, which left more room for easing of monetary

policy. The Governor of the Bank of France expressed satisfaction with recent French progress on a number of fronts.

The main question raised concerning the United States, Mr. Daane continued, revolved around the possibility of a reduction in interest rate levels. There was a clear interest on the part of the governors--including those from countries that had been gaining dollars--in seeing a reduction in the level of U. S. interest rates. The feeling was that rates in general were too high and that the key to a reduction lay in the United States.

With respect to the System's recent Regulation Q action, Mr. Daane observed, the governors asked--not in a critical way--why ceilings had been suspended only on CD's of up to 89 days' maturity rather than on all maturities. His response had been that the System had wanted neither to encourage an undue amount of intermediation nor to expose the United States to a large outflow of Euro-dollars. The discussion of the U. S. balance of payments problem had been surprisingly quiet. In his comments he had indicated that the U. S. balance of payments picture was rather bleak, but that recent developments in the trade balance were a bright spot. As to the U. S. economic situation, he had reported that the risks on the down side had increased recently but that there still was a problem of inflation to which the U. S. authorities were not oblivious. The governors seemed reasonably sympathetic with this country's efforts in the area of demand management and some even appeared to be rather envious of its performance on this score.

In the evening meeting, Mr. Daane continued, Dr. Zijlstra raised the question of exchange rate flexibility, asking for views on two specific matters: the "automatic crawling peg" and interim floating rates. There was absolutely no support for the automatic crawling peg. He (Mr. Daane) tried to shift the focus to the kinds of specific questions now being considered in the International Monetary Fund, but without success. The discussion of the second question devolved into a debate between the Canadians and others regarding Canada's recent move to a floating rate. There was general dissatisfaction--which he shared--with the way in which the Canadian action was taken, with the absence of clear objectives, and with the lack of any sense of the time within which there would be a move back to a fixed rate. The Canadians made the same defense they had made on other occasions--namely, that they had no other means of coping with the very large inflows that were occurring, and that they had been unable to establish a new fixed rate because of uncertainty as to its appropriate level. They also expressed their allegiance to the Fund's Articles of Agreement, and noted that the decision had been made by the Canadian Government and not by the Bank of Canada.

Mr. Daane remarked that he had attended only a part of the July 7 meeting of Working Party Three with Mr. Solomon, and would not comment on developments there in light of Mr. Solomon's report in his memorandum of July 13.[1] On July 8 he and Mr. Solomon had

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1/ Copies of this memorandum were distributed to the Committee on July 15. A copy has been placed in the Committee's files.

participated in a meeting of the deputies of the Group of Ten. That meeting had been called to consider further the question of exchange rate flexibility, following up the discussions that had been going forward in the Executive Board of the Fund. Press reports had indicated that the United States was undertaking a major initiative in the area of flexible exchange rates. However, Under Secretary Volcker made it clear that this country was not proposing anything new, but was simply carrying forward discussions that had been under way for some time in the Fund. Apparently, what had sparked the story in the press was the distribution by someone at the Fund of a U. S. paper presented by Executive Director Dale suggesting changes in a draft of the Fund report now in preparation. That report, which was being prepared for consideration at the Fund and Bank meetings this fall, would consist of two parts. The first part would be an objective review of the whole subject of exchange rate flexibility, setting forth the pros and cons of the various issues involved. The second part would consist of the conclusions of the Executive Board. The second part, which obviously was the more difficult to prepare, was the subject of discussion at the deputies' meeting.

To sum up the present status of the matter, Mr. Daane said, it was agreed that much had been accomplished under the par value system involving stable but adjustable parities that had been established at Bretton Woods. There was agreement that further consideration should not be given to unlimited floating rates, to substantially wider margins, or to automatic crawling pegs. The

areas for possible further consideration included, first, some small widening of margins; second, small and prompt changes in parities, when necessary to ward off an incipient fundamental disequilibrium that would eventually necessitate a large change; and third, transitional changes in parity. The second possibility was viewed as likely to be the most fruitful line for further consideration. All involved the overriding question of whether they would require changes in the Fund's Articles of Agreement, but that question was left unresolved.

Mr. Daane observed that there probably would be a meeting of the ministers and governors of the Group of Ten on the eve of the Fund and Bank meetings this fall. It seemed clear that there would be no consensus on the matter, and that it would be carried over for further study during the next year.

One interesting sidelight, Mr. Daane continued, was that the discussions were of a character quite different from the earlier deliberations on Special Drawing Rights because there was division within the Common Market involving more than a split between the French and other members. The Germans and Italians were much in favor of adding flexibility to the exchange rate system. The French, Belgians, and some others (most notably the Japanese) were completely negative, and the British were not inclined to take a firm stand. The U.S. position was that it was not seeking a lot of revaluations--which, it thought, would be bad for the dollar--but it was seeking a mechanism under which any necessary changes in parities could be made in a less disruptive manner than in the past.

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

> One member of the Committee--as Governor Daane has already told you--as well as staff members who were in Europe for meetings on the Fourth of July weekend and in the following week did not encounter a great deal of anxiety about the U. S. balance of payments. Mr. Solomon has suggested that perhaps this was because Europeans are preoccupied with worries about their own inflations. It may be, too, that central bank and government people in Europe are well enough informed to understand that monetary policy here is still one of restraint. And, of course, the news of the first-quarter balance of payments was stale, and people in Europe could not yet be aware that the second-quarter liquidity deficit will eventually be published at something like $1-1/2 billion, that it was really well over $2 billion when adjusted for special transactions, and that the official settlements deficit was also over $2 billion. These are quarterly figures, not annual rates, and they follow first-quarter deficits of a broadly similar order of magnitude. A natural question to ask is what view we in the United States, and at the Federal Reserve, should be taking of figures like these?
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> Odd as it may sound, I believe there is less call for alarm now than in July a year ago, or two years ago, or three years ago. Let me take those situations in chronological order.
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> In July 1967, we had come through a half year in which the adjusted over-all deficit was only $2 billion, about half as large as this year's. But an expansionary money policy was paving the way for a new acceleration of price inflation in this country and a new upswing in U. S. imports.
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> In July 1968, a state of euphoria about the international standing of the dollar was beginning to set in. This was after the new two-tier gold system had begun to look workable, after heavy foreign buying of U. S. equities had been building up, and after grandiose ideas about the French franc had collapsed. The intake of funds through the Euro-dollar market by U. S. banks was growing. But the U. S. trade surplus had almost disappeared, and before the end of 1968 our net exports of goods and services were going to be down to a rate of only $1-1/2 billion.
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> By July 1969, the worst had passed--in some respects. Net exports were clearly headed upward at last. Monetary

policy was appropriate to the country's needs, both with respect to the balance of payments and with regard to the more strictly domestic aspects. A basically very ugly balance of payments position was being disguised and beautified by an unbelievably large volume of borrowing abroad by U. S. banks. Of course we knew very well that could not continue.

Now, for the first half of 1970, the official settlements balance, which was in surplus a year ago because of the Euro-dollar borrowing, is showing a deficit of over $5 billion. This was due partly to $1-1/2 billion of net repayment of U. S. liquid liabilities to commercial banks abroad during the half year. The other $3-1/2 billion, representing the half year's deficit on everything else, is of course a very large sum--a far larger deficit than we can sustain for very many half years.

Yet, as I suggested at the start, there may be reasons why we should be no more concerned about the U. S. balance of payments this July than we were a year ago. Since then the annual rate of net exports of goods and services has increased by $2 billion. On the other hand, foreign buying of U. S. equities has turned negative and sales of U. S. corporate bonds abroad have shrunk, with a net adverse swing for U. S. stocks and bonds at an annual rate of something like $3 billion. Partly offsetting this, U. S. purchases of Canadian and other foreign securities have been curtailed greatly--though probably only temporarily.

Overall, the current and long-term capital accounts taken together seem to have come out about the same in the first half of this year as in the first half of 1969. But the shift in composition between trade and capital flows is encouraging. This judgment rests on two things: first, an assumption that sizable long-term capital inflows will eventually resume, and second, on the proposition--which admittedly is still to be tested--that because we are making progress toward stabilization of prices and costs in this country we can hope for more improvement in the current account of the balance of payments.

I have been speaking of the current and long-term capital accounts, and especially of transactions that eventually get recorded by our statistical apparatus. At the moment our records for the second quarter still have many gaps. But it seems not unlikely that as much as half of the $3-1/2 billion deficit in the first six months of 1970--and certainly a larger proportion than half in the second quarter--will be ascribed eventually to unrecorded and unreported movements of funds into Canadian dollars, German marks, and Euro-dollar deposits. If ever movements

> of these kinds were to become an unceasing one-way torrent, we would have a true balance-of-payments crisis on our hands. I do not believe we are at that point now. Admittedly, these movements may not be quickly reversible. Last year's flow of unidentified U. S. funds into Euro-dollars was probably not reversed, but much of last year's flow into German marks probably was, after the October revaluation. Reversible or not, these movements are at least not continuous. They can be explained by reference to particular conditions in the Euro-dollar market and in the exchange markets for particular foreign currencies--conditions that are changing from month to month.
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> For the time being, therefore, I continue to regard the balance of payments situation as one that calls for maintenance of as much restraint in U. S. monetary and fiscal policies as the economy can stand, combined with watchful waiting, rather than one calling immediately for new measures.
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> For the longer run, our commitment to the SDR philosophy of rational planning of the growth of international monetary reserves requires us to achieve a better equilibrium in our external accounts. We are committed not to pump unwanted billions of dollars into foreign monetary reserves, and we do not have enough gold or SDR's to pay for limitless deficits.

Mr. Hickman asked what effect on the official settlements balance Mr. Hersey would expect if there were a further downward adjustment of interest rates in the United States without corresponding declines in rates abroad.

Mr. Hersey replied that the answer would depend in large part on the rate differentials U. S. banks would be willing to pay in order to avoid reducing their Euro-dollar borrowings below the reserve-free base. He personally would consider the matter to be less significant than effects on the balance of payments through the underlying economic situation, since much of the Euro-dollar borrowings would have to be repaid at some point in any case. It would, of course, be undesirable to have the repayments concentrated in a

short period. Insofar as the objective of avoiding a heavy concentration of repayments was to be served by national interest rate policies, he thought it was incumbent on Germany and the other countries whose domestic policies had tended to keep Euro-dollar rates high to reduce their rates, rather than on the United States to hold its rates at high levels. The recent small reductions in discount and Lombard rates in Germany were to be welcomed, and he hoped the Germans would take additional actions of that sort before long. In general, while he thought that from the point of view of the payments balance it was important that the United States hold to an anti-inflationary policy, he did not believe that that required this country to maintain the highest interest rates in the world.

Mr. Brimmer noted that it had been suggested that the United States was ahead of Germany--and of European countries in general--in eliminating excess demand from its economy. He asked whether that might not imply a lag in the ability of European countries to ease monetary policy. If so, the United States might face the prospect of continued capital outflows for some time.

Chairman Burns said it was his impression that the European countries were eager to follow the United States in reducing interest rate levels if this country took the lead in that regard. Mr. Daane remarked that he shared the Chairman's impression. Mr. Maisel added that he would not be disturbed by capital flows arising from the kind of lag Mr. Brimmer had mentioned; indeed, one purpose for holding monetary reserves was to permit countries to tolerate such lags.

Mr. Hickman commented that in his judgment the United States should take the lead in lowering interest rate levels, and he viewed as constructive what had already been accomplished in that regard. However, in light of the current very large deficits in the U. S. balance of payments, he had some question about the length of the lead the United States could afford to take if it were not to damage confidence in the dollar.

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 June 23 through July 15, 1970, and a supplemental report covering the period July 16 through 20, 1970. Copies of both reports have been placed in the files of the Committee.

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

> In general, pressures on financial markets have abated since the Committee last met and interest rates have moved lower--in some cases substantially--as the written reports to the Committee describe in some detail. The massive shift of credit from the commercial paper market following the Penn Central insolvency has been accommodated so far by the banking system in a relatively smooth fashion, although beneath the surface a number of frantic negotiations were required and serious problems still remain. The Federal Reserve contributed to this orderly adjustment process in three ways: first, through the Board's prompt action to remove Regulation Q ceilings on short-term CD's; second, through reassurances to member banks that the discount window was available in case of need and by indications that the System would provide the reserves required for a shift of credit back into the banking system; and third, through the maintenance of comfortable money market conditions through open market operations supplemented by increased discount window use. In addition, the slowdown

in the economy and the recent disturbances in the financial markets, particularly the decline in the stock market, have tended to lessen inflationary expectations, even though there is continued market concern about cost-push pressure on prices.

The problem of the moment does not appear to be so much one of general pressures on financial markets, even though credit demand remains strong. Rather it appears to be a more selective problem reflected in both the commercial paper market and the corporate market and arising out of the enhanced sensitivity of investors to credit risks. While the commercial paper market has performed better since the first week following the Penn Central affair, some continued attrition must be expected as investors discriminate against two types of borrowers in the market. The first type is the lower-rated industrial concern or finance company--a Baa rated concern, for example--that places paper in the market through a dealer. Dealers are finding considerable investor resistance to such paper, and more and more firms are being forced into the banks. Fortunately most, but not all, of the lower-rated firms probably have 100 per cent bank line coverage. But these same firms--and indeed other similar firms that are not involved in the commercial paper market--are also experiencing difficulty in raising funds in the corporate bond market, as the widening spread between Aaa and Baa yields testifies. For some of them--particularly those with expanding financial needs--there is a real question of whether they can find adequate financing from any source.

The second type of problem involves a number of finance companies that issue paper directly and whose parent concern is currently experiencing a poor profit performance or some other type of problem. Investors have been shying away from these issuers--although day-to-day experience varies--even though the finance companies are themselves in good shape and are considered by the banks to be perfectly good credit risks. While banks have been willing to negotiate additional credit lines and to purchase receivables without recourse, the sheer magnitude of the amounts in question--sometimes involving legal lending limits for the banks--could make the problem a serious one if the drain continues. There is, consequently, a risk that the problems of a large finance company in finding financing or a series of failures of smaller concerns could set off a general deterioration of market conditions, and we should be alert to that possibility.

The Treasury bill market--as the Government and agency securities markets generally--has benefited from the investor shift towards quality. Despite the fact that the Treasury has raised $5 billion of new money in the bill market over the past four weeks, rates have declined and a favorable atmosphere persists. In yesterday's regular Treasury bill auction average rates of 6.38 and 6.44 per cent were set for three- and six-month bills, respectively, down 25 and 49 basis points from the levels established in the auction just preceding the last meeting of the Committee. Dealer bill positions are substantially higher than the abnormally low level at the time of the last meeting, reflecting mainly acquisition of new tax-anticipation bills originally purchased by banks in the special Treasury auctions. They do not appear to be excessive, however, judged by any normal standard, and as the blue book[1/] notes there should be a substantial demand for bills over the next few weeks.

In the conduct of open market operations, our main goal over the past four weeks was to make sure that money market conditions--particularly as reflected in the Federal funds market--were kept comfortable amid the churning caused by developments in the commercial paper market. In this our work was both assisted and complicated by the apparent willingness of member banks to make greater use of the discount window. Early in the period, we decided that if there was good evidence that member banks were acquiring reserves by increasing their takings at the window we should hold back on reserve supply through Desk operations. As a consequence, in the two weeks ending July 15 borrowings turned out to be quite high, but the resulting high net borrowed reserve figures had no market impact, as participants focused on the comfortable level of the Federal funds rate. The week ending July 15 was, in fact, complicated by some of the largest underestimates of reserve drains from market factors that I can ever recall in the projections. As the week progressed we

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

supplied a very large volume of reserves and the increased willingness of banks to borrow tended to minimize the impact of the reserve shortfall on the money market. With that experience behind us, I would tend to agree with the blue book forecast of a more normal level of borrowings at the window. At the same time we should be alert to the possibility that a freer use of the discount window might tend to result in a greater supply of reserves than we might otherwise want.

As far as the aggregates are concerned, the credit proxy is expanding far more rapidly than had been projected at the time of the last meeting. So far the expansion appears to be limited to a replacement of credit previously extended through the commercial paper market rather than a growth of total credit in the economy. As long as this is the case there would appear to be little cause for concern. The staff projection of a 14 per cent annual growth rate for the third quarter as a whole appears to me to be on the conservative side, since the banking system will be called on to make good a further shortfall of credit in the commercial paper market.

The money supply is currently projected to grow at a 10 to 11 per cent annual rate in July, with some part of the growth perhaps related to a jump in compensating balances associated with the negotiations for additional bank lines and take-downs of lines by refugees from the commercial paper market. For the quarter as a whole, however, the Board staff projection of a 5 per cent growth rate is identical with the path set forth at the time of the last meeting. The New York Bank staff, on the other hand, is projecting a more rapid 6.5 per cent growth rate for the quarter, with an 8 per cent growth rate for August in contrast to the 2 per cent rate projected by the Board. Should the New York projection turn out to be right, alternative B of the directive[1] would call more clearly than alternative A for some firming of money market conditions over the period until the Committee meets again, even keel considerations permitting.

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

The Treasury, as you know, will announce next Wednesday the terms of its refunding of $6.5 billion maturing August issues, of which $5.6 billion is held by the public. Some participants in the Government securities market appear to favor a straight exchange offering, but others are for a combined exchange-cash offering. The latter approach would appear to fit in well with the Treasury's need for some $4 billion additional cash by early September, since it would cover attrition and permit some cash to be raised in connection with the refunding. Incidentally, I would plan to exchange the System holdings of $489 million maturing issues into the new issues offered by the Treasury in proportion to the public's expected subscriptions.

Market sentiment coming into the refunding is more favorable than it has been for some time and the technical position of the market is good. However, as the green book[1] sets forth in some detail, the Treasury's cash outlook appears to have deteriorated substantially as expenditures are running above, and receipts below, budget estimates. Cash needs over the balance of the year now appear to be well above estimates at the time of the last refunding and there is some risk that the disclosure of these needs could have an adverse effect on market sentiment. Incidentally, there is a possibility--I hope a remote one--that the Treasury might run short of cash temporarily in mid-August. In this connection, counsel for the Committee has indicated that paragraph 2 of the continuing authority directive authorizing the New York Bank to lend up to $1 billion directly to the Treasury has been in a state of _de facto_ suspension since July 1 because of a delay in Congressional action to renew the System's authority to make direct loans to the Treasury. That legislation should be enacted shortly and paragraph 2 would then become effective again.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 23 through July 20, 1970, were approved, ratified, and confirmed.

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

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:

> In the past several weeks a somewhat better atmosphere has developed with respect to the business situation. It cannot be said with any certainty that the low point in over-all activity has been reached, even though some of the incoming statistics recently have shown less weakness. But it does appear more probable than a month or two ago that significant further declines may be avoided. Thus, industrial production dropped considerably less in June than in previous months, and the earlier downturn in manufacturers' new orders appears to have lost momentum. Retail sales data indicate that consumer spending is holding up relatively well, as expected, and the June increase in housing starts provides confirmation that that sector will now very likely be in a strengthening trend. New layoffs of workers also have diminished considerably in the last month or so, although the over-all employment picture continues quite weak.
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> The first official GNP estimates for the second quarter, which became available late last week, also add to the impression of a bottoming out in the business decline. The increase in current dollar GNP, at $10.6 billion, was appreciably larger than in the first quarter and real GNP increased very slightly, in contrast to the sizable first-quarter decline. The composition of the GNP change, however, was weaker than these summary figures imply. The expansion in final sales slowed markedly, despite large supplements to personal income resulting from current and retroactive increases in social security and Federal pay rates, and the saving rate rose sharply to its highest level in two years. Business fixed investment showed virtually no increase for the second quarter in a row, while Federal purchases

declined on balance and expansion in State-local purchases slowed. In short, the improvement in GNP depended almost entirely on an ending of the decline in inventory investment, which, with June figures still missing, is estimated to have been a little higher than in the first quarter.

The GNP data also showed a significant decline in the rate of inflation, with the deflator rising in the second quarter at a 4.2 per cent rate--well under the first-quarter rate and less than we had been expecting. Not too much should be made of this, since we understand that the moderation--aside from the fact that the first-quarter deflator incorporated the effect of the Federal pay raise--resulted mainly from a shifting of the relative weights in the index towards less inflationary sectors. But other developments also indicate that some progress is now being made in the area of prices and costs. Farm product prices have declined in recent months, reflecting mainly improved supplies, and have contributed to a considerable slowing of the rise in the over-all wholesale price index. Sensitive industrial materials prices also have declined recently, and the incidence of price increases among industrial commodity groups in June was the lowest since last August. On the cost side, reductions in force have brought a resumption of the rise in labor productivity, which goes back two quarters in manufacturing and was extended last quarter to the private nonfarm sector as a whole. The gains in productivity, of course, serve to offset part of the continued rapid rise in employee compensation, though admittedly not much offset is possible in such cases as trucking, where the teamsters' settlement finally turned out to be 13 per cent per annum.

As to the future, the staff continues to expect a modest recovery in economic activity during the second half and extending into 1971. The principal features of the recovery, as we see them, will be a recovery in residential construction, more rapid growth in State-local capital outlays, and a reasonably strong expansion in consumer spending that will moderately exceed prospective growth in disposable income. The business community also generally appears to be expecting an upturn, judging from many of the District contacts as reported in the red book.[1] In both cases, however, the

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

emphasis should be placed on the modest character of the outlook. Earlier expectations of a vigorous rebound, widely held among private forecasters at year-end, seem virtually to have disappeared. Now there is general agreement that the shock of the stock market decline, the larger-than-expected drop in earnings, the liquidity squeeze, the rise in unemployment, and the sluggish economy of the first half have introduced a tone of caution in business planning and consumer behavior.

The question is whether the implications of this new caution are fully taken into account in our projections, and in those of businessmen generally. In the capital spending area, for example, evidence is accumulating that sizable cutbacks are in progress in many industries. Dollar outlays for fixed capital, as I have noted, are now shown in the GNP accounts to have increased hardly at all since the fourth quarter of last year. Physical output of business equipment as measured by the industrial production index has dropped in each of the last three months, by a total of 4-1/2 per cent. And many of the District summaries comment on reports of cutbacks and stretchouts of capital spending projects which have yet to show up in the figures. Similarly, some Districts comment that businessmen feel that inventories are too high. The data suggest a mixed picture, but with over-all stock/sales ratios relatively high and the ratio of inventories to order backlogs in durable goods manufacturing very high and still rising, there certainly would seem to be room for some cutbacks if businessmen seriously want to tighten up their operations.

For my part, therefore, I am not so certain that the business decline has come to an end. I can readily visualize a relatively sharp falling off in business capital outlays, already in progress and extending into 1971, with consequent effects on employment, incomes, consumption, and inventory balance. And I can also imagine a period of inventory liquidation which, though relatively brief and followed by some rebuilding of stocks, would put off the over-all business recovery until later in the year or early 1971.

Even if a resumption of the rise in business activity is now at hand, however, every indication is that it will be slow and halting--probably interrupted in the fall by strikes. The profits squeeze, moreover, makes certain that business will be striving for increased efficiencies,

that productivity consequently will continue to improve, and that gains in output will be associated with a relatively smaller pickup in employment. Unless the labor force continues to decline, which it has done over the past two months but which seems extremely unlikely for any extended period, one implication of moderate output growth would be a continuing gradual uptrend in unemployment.

Under these circumstances, and with the economy now operating well below capacity, it seems to me that credit should be made rather freely available. There is much to be gained, and little risk, in encouraging more credit use to stimulate housing, State-local construction, and consumer durable goods buying, and to finance the inventories that firms wish to hold. The time may even have come, given the lags in spending and the apparent curtailment in current plans, to provide a little encouragement to capital spending plans. This, it seems to me, requires declining interest rates and a sense that external financing is and will remain reasonably available. Good progress has been made toward lower interest rates over recent weeks, but I believe that further progress would be highly desirable in the months ahead. Toward this end, and abstracting from the near-term constraints of "even keel," the System should be prepared to encourage and accept substantial rates of expansion in money and bank credit.

Mr. Axilrod made the following statement concerning financial developments:

Most of the financial market pressures of concern to the Committee over the past several weeks appear to have abated, although the commercial paper market remains rocky. Long-term market interest rates have dropped about 40 to 70 basis points from their mid-June peaks. And stock prices, while fluctuating, are on their most recent reading about 5 to 15 per cent above late-May lows, depending on the index used. Thus, the rather generalized crisis of confidence in which investors appeared to be abstaining from both stocks and bonds seems to have passed.

In its wake, however, there do remain problems in particular areas, notably the commercial paper market. And even in the stock and bond area investors have become much more selective. As a result, while prices have improved on these securities, higher quality issues have

been favored. In the bond market the yield spread favoring high-grade corporates has widened by about 25 basis points since mid-June, and in the stock market prices have risen relatively less on the American Exchange than on the New York Exchange. In short-term credit markets, Treasury bill rates from the 3-month area out have dropped 20 to 50 basis points since the last meeting of the Committee, while private short-term rates have dropped considerably less and some, like commercial and finance company paper, have shown no rate decline at all.

Under the circumstances, even with the much improved tone in stock and debt markets generally, the Committee probably should approach credit markets with a certain wariness. With the commercial paper market in a parlous state, a relatively large rechannelling of credit flows appears to be in process. And profit and liquidity conditions remain difficult enough in some business and financial sectors of the economy so that the odds on another confidence crisis, generated by the failure or near-failure of some sizable company, are certainly not trivial, though they well may have diminished.

In the month of June outstanding non-bank-related commercial paper dropped around $1 billion, seasonally adjusted. The unadjusted weekly data we have for non-bank commercial paper showed a $2 billion decline in outstandings in the week ending July 1, followed by little net change during the next statement week--but then, rather surprisingly, followed by a further $1 billion drop in the week ending July 15. The weakness thus far in July is occurring at a time when in past years there has been at least some seasonal recovery.

At the same time as outstanding commercial paper has declined, total loans and investments of banks have been increasing at an accelerated pace, financed mainly by aggressive bidding for CD funds by banks in the 30-89 day area where Regulation Q ceilings have been suspended. During the past three statement weeks, large negotiable CD's outstanding are estimated to have risen by about $3 billion, reflecting the sharpest weekly increases in the history of the series. The effect of this unusually rapid recent CD growth on bank credit expansion can best be seen in the weekly adjusted bank credit proxy series, which rose by about $4 billion over

the three statement weeks ending July 15--roughly the period since Regulation Q was suspended. This accelerated rise has led the staff to forecast, given roughly prevailing money market conditions, a 17 per cent annual rate of increase for the adjusted proxy for July over June and a 14 per cent rate of increase for the third quarter.

While the growth of bank credit is accelerating markedly, as compared with the second quarter, it does not seem as if this will be accompanied by a near-term upsurge in credit raised by private sectors of the economy. U. S. Government credit demands have been enlarged in recent weeks and will probably be larger, after allowance for seasonals, in the third quarter than in the second. But the volume of funds raised in private credit markets, while remaining sizable by historical standards, does not appear to be rising and may even be dropping off. As just noted, there has been a continued attrition in outstanding commercial paper. And in other markets, corporate bond issues are likely to be at a slightly slower pace in July as compared with June, while State and local government offerings are expected to show little net change between June and July, despite the drop in interest rates and the greater availability of bank funds. Thus, the early summer data that we have appear to be consistent with a view that at the moment the growth in bank credit primarily represents a rechannelling of credit flows. And while the increase in bank credit availability might encourage somewhat greater total borrowing as time goes on, this would not be an unwelcome prospect, given the outlook for a relatively slow rate of economic growth.

The dimension of the prospective expansion in the adjusted credit proxy--14 per cent in the third quarter as against 6-1/2 per cent in the second--looks considerably less fearsome when funds raised by banks through short-term market instruments are excluded, as one might on the grounds that these instruments are fundamentally little different in economic and financial effect from short-term debt instruments issued by borrowers directly. After subtracting large CD's, Euro-dollars, and bank-related commercial paper from the adjusted credit proxy, the growth rate in July is reduced from 17 to 10 per cent and for the third quarter from 14 to 8 per cent. The comparable figure for the second quarter would be reduced from 6 to 4 per cent.

In terms of open market operations, the calmer atmosphere in over-all financial markets would seem to permit the FOMC to move back to placing greater emphasis on monetary aggregates, a desirable development in my view. At the same time, remaining financial uncertainties, particularly as they pertain to the commercial paper market, make it desirable to permit an enlarged expansion of bank credit should that be required, as seems to be the case at the moment, at least to sustain normal financing flows. Finally, I continue to believe that the real rate of return on capital--that is, the expected return on capital outlays after allowing for price increases--is diminishing; and if this is not to have an excessively dampening effect on the economy, long-term interest rates should be encouraged to decline further. Such a decline may be consistent with a 5 per cent rate of growth in the money supply in the third quarter, but I would continue not to be averse to a somewhat higher rate of growth--taking into account that the real value of cash balances (after allowing for the effect of price increases) dropped in the second half of 1969 and did not increase at all in the first half of 1970 despite a 4 per cent annual rate of rise in the nominal value of the outstanding money supply. I take the decline in the real value of cash balances over the past year and the accompanying sharp rise in market interest rates to be good over-all indicators, when taken together, of a liquidity squeeze that is by no means yet unwound. Thus, I would tend, in alternative B, to permit, or encourage, the money supply to grow at around a 6 per cent annual rate--which would, of course, be close to the New York Bank staff projection mentioned by Mr. Holmes.

Mr. Brimmer asked whether the reasons were known for the differences between the growth rates in money projected at the Board and the New York Bank. The difference in the projections for August--for increases at annual rates of 2 and 8 per cent, respectively--seemed particularly large.

Chairman Burns remarked that before Messrs. Holmes and Axilrod responded to that question he might note that the record showed some substantial differences not only between alternative projections but also between projections and events. For example, in May the money supply had increased at an annual rate of 3.5 per cent, but early in that month the Board staff was projecting a 9 per cent rise.

Mr. Holmes said he did not know the specific reasons for the difference in the figures for August, but in general such differences reflected the fact that the two groups of projectors worked independently of each other. There was still some difference between the Board and New York Bank figures for July; perhaps as the July picture became clearer the projections for August would be brought closer together. With respect to the growth rate in money for the third quarter as a whole, he thought the difference between the Board's projection of 5 per cent and New York's of 6.5 per cent was quite small, considering that only a few weeks of the quarter had elapsed.

Mr. Axilrod agreed with Mr. Holmes that the difference between quarterly growth rates in money of 5 and 6.5 per cent was very small for projections--particularly those made this early in a quarter--given the past margin for error in such projections. However, a difference between 5 and 6.5 per cent might be quite significant when considering targets for the Committee's operations.

He added that the Board's staff had arrived at about the same projection for third-quarter money supply growth, given GNP and bill rates, using two different techniques--the regular judgmental procedures that yielded monthly as well as quarterly projections and alternative procedures employing the quarterly econometric model.

Mr. Brimmer remarked that in his judgment the distinction Mr. Axilrod had drawn between targets and projections was a crucial one. He would hope that any differences in recommendations for targets would reflect different assessments of the needs of the economy rather than simply differences in projections.

Mr. Hickman said he considered the 5 per cent growth rate in money suggested in the blue book as a target for the third quarter to be quite reasonable under existing circumstances. If developments over the next month suggested that such a growth rate could not be achieved without a decline in interest rates the Committee could consider the matter at its next meeting. He then asked whether there would be any substantial period before the next meeting in which operations would not be constrained by even keel considerations.

Mr. Axilrod replied that the answer would depend in part on how the Committee chose to interpret "even keel" at this point; as the members knew, that question had been considered in a recent

staff memorandum.[1/] The terms of the Treasury's August refunding would be announced on July 29 and the payment date would be August 17, the day before the next scheduled meeting of the Committee. Thus, under a traditional interpretation of even keel, System operations would be constrained during virtually the whole inter-meeting period--except perhaps for the remaining three business days of this week. Personally, however, he had always had a bias toward a more flexible approach to even keel, particularly at times when the shift under consideration was in an easing direction. To illustrate the kind of flexibility he had in mind, he noted that the Federal funds rate often rose during periods of Treasury financing as a result of dealer financing demands. If at the same time the aggregates were growing more slowly than the Committee desired, he would not consider it inappropriate to supply additional reserves in the process of resisting such a rise.

Mr. Maisel commented that if a traditional approach was to be followed it was important that the money market conditions prevailing at the beginning of the even keel period be the appropriate ones. For example, if revisions made this week in the projections of the monetary aggregates were generally downward, it would be desirable to end the week with a lower Federal funds rate than otherwise.

1/ The memorandum referred to was entitled "'Even keel' and the monetary aggregates" and dated July 17, 1970. A copy has been placed in the Committee's files.

Mr. Holmes noted that there would not be much opportunity to make such an adjustment since the next revisions of the projections would not be available until late Thursday, when only one business day would be left for the purpose.

Mr. Eastburn remarked that he had found the staff memorandum to be quite helpful. He shared Mr. Axilrod's preference for a more flexible approach to even keel. In general, he thought it would be better to vary money market conditions as needed to keep the aggregates on target--and meet any problems posed for the Treasury by a restructuring of financings--than to try to compensate after a financing for large misses in the aggregates resulting from the maintenance of an even keel.

Mr. Daane noted that, as the staff memorandum pointed out, the Treasury might have to price new issues more generously if greater volatility in market conditions during financings increased the risk to underwriters. While he thought there might be merit in the arguments for a more flexible approach to even keel, he was not prepared to go so far as to force the Treasury to restructure its financing techniques.

Chairman Burns commented that some flexibility no doubt was desirable; the Committee would not want to adhere slavishly to an even keel policy. However, too large a deviation from even keel might at times result in a potential failure of a financing, and a consequent need for large-scale operations by the System.

Mr. Daane said he had two questions regarding the draft directives. First, the intended difference between the two alternatives for the second paragraph was not wholly clear. Secondly, he was puzzled by the proposal to eliminate the reference to "liquidity strains" in alternative A and to both "market uncertainties" and "liquidity strains" in alternative B. In his judgment such deletions would imply that the situation had improved more than it in fact had.

Mr. Holmes observed that, as he understood it, the difference between the two alternatives for the second paragraph was one of emphasis. Alternative A, like the directives adopted on May 26 and June 23, emphasized interest rates and financial market conditions; alternative B, like the directives issued earlier in the year, emphasized the monetary aggregates. It was entirely possible that operations would be the same no matter which alternative was adopted. However, if the money supply were growing more rapidly than targeted, the Desk would react more quickly under alternative B than under A.

Mr. Swan remarked that while there might be some difference in emphasis under the two alternatives, that difference was likely to be small since operations would be constrained by even keel considerations--even if the Committee should decide to follow a somewhat more flexible approach to even keel.

Mr. Holmes concurred in Mr. Swan's observation.

Mr. Hickman agreed that the choice between the two alternatives was not likely to have much of an impact on operations, noting in that connection that the same targets were suggested for both in the blue book. Nevertheless, he thought it would be desirable to adopt alternative B, since it made clear that the Committee was not indifferent to the growth rates in the aggregates.

In response to a question by Mr. Sherrill, Mr. Holmes said he thought alternative B would involve a shade more flexibility with respect to the interpretation of even keel.

Mr. Holland referred to Mr. Daane's question regarding the proposed deletion of certain references in the alternatives for the second paragraph. With respect to alternative A, he remarked that the staff had suggested deleting "liquidity strains" because it appeared that such strains had become more selective in recent weeks and were now focused mainly in the commercial paper market. On that ground, it had seemed that the problem would be adequately indexed by the reference in the second paragraph to "market uncertainties", which it was proposed to retain. As the members would note, the draft of the first paragraph included a statement on developments in the commercial paper market.

As to alternative B, Mr. Holland continued, the staff had suggested deleting references to both market uncertainties and liquidity strains from the first sentence on the ground that such references would be essentially redundant, given the proposed proviso

clause relating to excessive pressures in financial markets. However, there might be advantages in retaining the references in the first sentence of the paragraph.

Chairman Burns commented that while the atmosphere in financial markets appeared to have improved recently there was little question in his mind that liquidity strains persisted beneath the surface. Accordingly, he thought a reference to such strains should be retained in the second paragraph of the directive.

Messrs. Daane and Hickman concurred in the Chairman's view.

Chairman Burns observed that he had been disturbed by the very high level of member bank borrowings in the last two statement weeks, and wondered whether the System should not have supplied more reserves to moderate the increase. He asked whether the sharp rise in borrowings was unexpected.

Mr. Holmes replied that the rise in the week ending July 15 was greater than he had anticipated. However, since the Federal funds market had remained comfortable, it had seemed desirable not to duplicate through open market operations the reserves the banks were acquiring by borrowing. There was an unexpectedly heavy reserve drain from market factors in the same week--some $1.2 billion, compared with a projection at the beginning of the week of about $100 million. As that shortfall became evident day by day the System made large reserve injections through repurchase agreements; indeed, a record volume of RP's was arranged during the course of the week.

Chairman Burns expressed concern over the risk of becoming accustomed to very high levels of member bank borrowings and of interest rates. He doubted that the economy could thrive if such conditions persisted.

Mr. Brimmer noted that borrowings had risen about $790 million during the three weeks ending July 15. However, a staff estimate indicated that about $480 million of that increase was related, in one way or another, to developments in the commercial paper market. After allowance for those developments, the rise did not appear unduly large.

Mr. Axilrod agreed that borrowings related to commercial paper developments were of a different character from other borrowings. He noted, however, that even such special borrowings had to be repaid, and the longer they remained on the books the more anxious the banks involved would be to liquidate them. As time passed the special borrowings were likely to become increasingly similar in the banks' view to regular borrowings; and he would expect a constant level of borrowings to be associated with upward pressure on the Federal funds rate.

Mr. Eastburn said he shared the Chairman's concern about the level of borrowings. He asked whether the Manager thought it would be possible to reduce that level through open market operations without having a marked effect on interest rates.

Mr. Holmes replied that he thought such an outcome was possible in the period ahead since the Desk probably would be supplying reserves in any case.

Mr. Morris remarked that, as he had advised the Board last week, he thought the recent suspension of Regulation Q rate ceilings for large-denomination CD's with maturities of 30 to 89 days was producing an undesirable concentration of outstanding CD's within a very narrow maturity range. He asked whether the staff had any view as to the probable consequences for the money market and the level of Euro-dollar borrowings by banks of a suspension of rate ceilings on longer maturities--say, out to six months.

Mr. Partee said he would want to have a detailed study made before attempting a final response to the question. His offhand reaction, however, was that an action of the sort Mr. Morris suggested would have little over-all effect on the banks' ability to attract CD money relative to funds from other sources, since they were already free to compete in the most important maturity segment of the market. However, the recent Regulation Q action had been designed to convey a sense of temporariness, in order to discourage banks from using the proceeds of CD sales for long-term lending and investing and from drawing down their Euro-dollar borrowings below the levels of their reserve-free bases. If ceiling rates were now suspended on longer-term maturities, that

sense of temporariness might be lost and bank operating policies correspondingly modified. No doubt such an action would improve the maturity distribution of CD's, although it was still too early to say how much maturities had shortened as a result of the partial suspension now in effect.

Chairman Burns noted that the average maturity of CD's had been decreasing even prior to the Board's action, apparently reflecting uncertainty about the likely course of interest rates.

Mr. Holmes added that most of the bankers he had talked with recently seemed to prefer the shorter-maturity CD's even apart from their competitive advantage in attracting such funds, since they hoped to roll them over later at lower interest rates.

Mr. Sherrill suggested that a shortening of maturities for the borrower (the bank) might actually represent a lengthening of maturities for the investor, since many of the latter were shifting out of the generally very short-term commercial paper market.

In response to a question from Mr. Brimmer, Mr. Morris said he would not expect banks to become more aggressive in their over-all bidding for CD's if the ceiling suspension were broadened, and he would therefore not expect any substantial impact. Despite the efforts of the Board, most banks seemed to regard the step already taken as the beginning of a permanent change, and decisions on Euro-dollar repayments seemed to be based chiefly on rate differentials. He also suggested that a liberalization of bank lending policies, which

the impression of temporariness had been intended to avoid, might actually be desirable. In any case, he was concerned that the limited suspension now in effect might be building an element of instability into the banking system and thought a broadening of that suspension would bring about a sounder liability structure.

Mr. Coldwell commented that fundamental questions might be involved in a broadening of the ceiling suspension. The original action had been taken in direct response to the problems in the commercial paper market. To extend that action without such immediate justification could, he suggested, have implications of a legal nature and in terms of competitive inequities among banks.

Chairman Burns suggested that the problem would resolve itself if market interest rates continued downward to levels at which present ceiling rates would again become competitive. More generally, the question Mr. Morris had raised probably could not be resolved satisfactorily by discussion today; staff study would be required.

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

Mr. Heflin commented that, except for the balance of payments and the general tone of the international exchanges, the surface information on economic and financial conditions now appeared more encouraging than at the time of the last two meetings. However, in spite of recent encouraging data on prices and production and the

welcome improvement in financial markets, there still were serious problems to be faced. The problem that concerned him most was the prospect of an acceleration in cost-push pressures. The disturbingly large teamsters' settlement and the likelihood that it would become the norm for the important negotiations still ahead could only aggravate the problem, and excessive wage increases undoubtedly would soon be reflected in the price indexes.

Because of their effects on both expectations and prices, Mr. Heflin said, he viewed the wage-cost increases as a threat to the recent improvement in financial markets--much of which he felt had been due to the better performance of prices over the past month or two. Also, if costs continued to rise, that would certainly aggravate the unemployment problem; although the unemployment rate had declined a little in June, it was likely to rise again, perhaps to levels above those projected in the green book. The combination of rising unemployment and any new difficulties in the financial markets would put considerable strain on the Committee's ability to maintain a moderate growth path for the aggregates. In sum, he thought the apparent improvement in conditions during recent weeks should be interpreted with caution.

Mr. Francis remarked that during the last six months the results of policy actions taken over the last eighteen months had been in evidence. Even the large injection of money in the second

quarter, which he believed was excessive, was not likely to stop the System's progress towards reduced inflation. Money generally affected spending over a number of quarters, and if the Committee could avoid a rapid growth in money from here on out, inflation would continue to slow. The recent general decline in interest rates indicated that the demand for credit was beginning to ease, and doing so with minimum disruption in the over-all level of economic activity.

Mr. Francis' main concern at this point was that the Committee might over-estimate the decline in inflation and, by the same token, the recovery in real growth. He was not as optimistic as the green book authors with respect to the outlook for inflation and real output over the remainder of the year. If the Committee followed the policy of moderate growth in the monetary aggregates it would correct the inflation and provide for resumption of a full-employment growth rate in the economy, but in his judgment that outcome would probably take several years--rather than several quarters.

It was Mr. Francis' belief that the price of correcting the inflationary excesses in the economy was going to be higher than had been anticipated. He would hope that monetary policy over the next year and a half would continue along the lines followed for the last year and a half. That moderate approach was working, and in his view its continuance was essential to the future stability of the U.S. economy.

Mr. Coldwell said he sensed several different trends in what appeared to be a transitional period. First, there were persisting inflationary expectations, which were being buttressed by a rising deficit in the Federal budget. Second, as Mr. Heflin had mentioned, unreasonably large wage settlements were being made; and that would have an impact on corporate profits and on prices. Third, although the likelihood of a deep recession seemed to have diminished, there were nagging doubts about the outlook. Layoffs were continuing, especially in defense-related industries, and profit margins were narrow. Finally, there seemed to be a longing for certainty in the face of such unsettling developments as the recent performance of the stock market and the Penn Central insolvency. Under those circumstances he thought the Federal Reserve could make its best contribution by serving as a stabilizing influence.

Mr. Kimbrel reported that businessmen in the Sixth District generally shared the feeling that the Federal Reserve was making considerable progress in attaining greater stability. Instances of price shading were beginning to appear for both services and products--especially citrus fruits and fabricated steel and aluminum products. Bankers in the larger cities of the District were generally pleased with the partial suspension of ceilings on large-denomination CD's, but they were somewhat apprehensive about competing aggressively for CD funds--a reaction which he understood

the Board had intended. Nevertheless, he thought most District bankers believed the suspension was a permanent move and that it would be extended soon to include the longer maturities. The liquidity of the banks had not improved a great deal, and he doubted that they were prepared to expand their loans significantly. Rather, bankers seemed to be directing their attention to improving their liquidity. It therefore seemed unlikely that a further move with respect to Regulation Q would result in aggressive lending by banks.

Mr. Treiber said it was his general impression that signs of weakness in the economy were mixed with signs of strength, and that prospects remained reasonably good for renewed growth in the not-too-distant future. However, he was concerned about the outlook for prices; convincing signs of fundamental improvement in the price situation were still lacking, while demands for wage increases had continued large. In addition, the Federal budget outlook for the new fiscal year had deteriorated.

As to policy, Mr. Treiber continued, he thought that for both domestic and international reasons the Committee should continue the approach now in effect without any basic change. Policy should remain flexible, poised to deal with any further market pressures that might develop--perhaps from unexpected sources. He would view a steady Federal funds rate in the

neighborhood of 7-1/2 per cent as appropriate for the coming period. However, it seemed unrewarding to seek to specify particular figures with respect to borrowed reserves, in view of the current unsettled conditions in financial markets and the increased use of the discount window.

Mr. Robertson expressed the view that the present stance of monetary policy was just about what it should be. There were signs of progress in slowing down the rate of advance in prices and in bringing about a resumption of moderate growth in the real economy.

Mr. Robertson added that he hoped Administration officials would refrain from making public statements about the appropriate course for monetary policy. In particular, he was concerned about the possibility that statements calling for an easier policy might be encouraging enlarged wage demands.

Mr. Hickman said he believed that the decline in economic activity was bottoming out and, as Mr. Robertson had suggested, that a resumption of moderate real growth was in prospect. He also agreed that there was some evidence that the rate of price advance was decelerating, although not as rapidly as would have been desirable. He thought present conditions called for holding to a policy of moderate growth in the monetary aggregates. Under such a policy he would expect to see continuing indications that inflationary pressures were subsiding.

Mr. Swan concurred in the policy views expressed by Messrs. Robertson and Hickman. With regard to the so-called "crisis of confidence" in financial markets, it was his view--which he believed was shared by Twelfth District bankers--that the situation had improved since the last Committee meeting despite lingering problems in the commercial paper market. Bankers in his District had participated willingly in the credit recycling process, increasing credit lines and making loans where necessary, and thus far none had requested special discount window accommodation.

With respect to economic conditions, Mr. Swan continued, the Twelfth District was sharing the kinds of problems facing the rest of the country, including those resulting from slowdowns of capital spending and efforts at cost cutting. Adjustments of those types were unavoidable, however, if progress was to be made in controlling inflation. The District also was being affected by some special circumstances, such as the employment decline in the aero-space industry. But, again, that was a part of a process of curtailing Government expenditures that was essential to the control of inflation.

Mr. Brimmer observed that he agreed with the staff's assessment of the economic outlook but differed from their policy prescription. Like others today, he thought monetary policy was on the right track and should hold to a steady course. Following up a comment by Mr. Robertson, he thought that statements by

Administration officials regarding appropriate monetary policy were creating confusion in the public mind as to the locus of responsibility for such policy. Those statements might also be creating expectations which, if disappointed, could only aggravate the situation.

Mr. Daane said he expected the shortfalls of capital spending from planned levels to be greater than the staff had projected, and he doubted that consumer spending would increase enough to fill the gap. He shared the concern expressed today about the large wage increases taking place. Questions arose as to whether or not validation of those increases by monetary policy could be avoided, reminding him of the similar issue that had been debated at length within the System some twenty years ago. The same problem was now being faced by many European countries and had been discussed at the July Basle meeting. Indeed, it could be said to have been uppermost in the minds of the governors there. The consensus view at Basle--which he shared--was that monetary policy could not attack the wage-push problem directly and could be expected to serve effectively only as a tool of demand management.

Mr. Galusha commented that the staff's projections of the unemployment rate in the first two quarters of 1971--5.6 and 5.8 per cent, respectively--struck him as realistic. He also believed that those levels were too high, and that if they were

realized both Congress and the Administration would come under irresistible pressure to relax fiscal restraint.

Others had suggested maintaining the present stance of monetary policy, Mr. Galusha continued. Presumably that meant seeking growth in money at about a 5 per cent annual rate. He would suggest instead that a 6 per cent growth rate be sought over the second half of 1970. In his judgment that would have only a modest effect on prices--there would be slightly less slowing in the advance of the GNP deflator--but it would have a significant impact on the general economic climate and on the rate of growth in real GNP in the first half of 1971. As to the formulation of the directive, he would favor returning to a primary focus on the aggregates.

Chairman Burns said he, like others, had been watching for signs of an economic recovery. While there were some such signs, a convincing case for an early upturn could not be made at present. The state of confidence had improved in the past few weeks, and he thought the System could be proud of its contribution to that improvement. But relative to the situation earlier in the year confidence clearly had deteriorated, and the consequences of that deterioration would continue to be felt for some time. The possibility that worried him most was not a sudden crisis, but rather the kind of slow erosion of confidence that

was less visible while it was occurring than it became months afterward.

The Chairman said he thought the unemployment rate might well continue increasing for a time. If so, that would be an unhappy development. On the other hand, he also expected a slowing in the rate of price advance--a development that the System had been working to bring about for a long time. In general, he was more optimistic regarding the outlook for prices than he had been for some time. The rate of increase in wholesale prices was diminishing; and he understood that the consumer price index for June to be published shortly would show some improvement, although not of a dramatic sort. It was important to remember that consumer prices typically lagged other prices.

Chairman Burns observed that the policy of monetary restraint was beginning to yield visible results, most significantly in improvements in productivity. Businessmen, reacting to the profit squeeze, were engaged in strenuous cost-cutting efforts. If the available figures were right, there had been a dramatic rise in manufacturing productivity over the course of the first quarter, and it appeared that an equally large increase might have occurred over the second quarter. Further gains in productivity could be expected if, as typically was the case, businessmen remained in a cost-cutting mood for a time after output began to increase. Such productivity

improvements should offset much of the effect on costs of the sharp increases in wage rates that were being negotiated. Wage increases of the recent magnitude were deplorable, and he hoped that the President's modest move toward an incomes policy would help to slow the rise. He had supported that move, as well as the President's recent statement regarding a ceiling on Government expenditures.

Chairman Burns said he believed the Committee's current policy was about on course. However, with unemployment likely to continue rising for some time and with price advances slowing, there seemed to be room for a slight relaxation of policy. So long as there had been no signs of improvement on the inflation front, a policy of restraint, carrying with it high interest rates, had been imperative. As he had noted earlier, however, he was concerned about the risk of becoming accustomed to interest rate levels that perhaps were higher than the economy could tolerate for an extended period. Although most rates had now receded from their peaks, they remained high by historical standards, and he thought a move toward lower rates was needed to forestall economic difficulties later on. That view was reinforced by his belief that the capital spending boom was ending, and that such spending would decline.

Accordingly, Chairman Burns observed, he would be inclined at this point to seek a slightly more liberal rate of growth of money. Since there would be slack in the economy for some time to come, such a course would not create the difficulties in the months ahead that it would have caused if adopted earlier. Given the recycling of lending activity through the banking system that was under way, he favored focusing on the money supply at this time and would not be disturbed by fairly rapid growth in bank credit.

The Chairman then called for the go-around of comments and views on monetary policy and the directive.

Mr. Treiber said it seemed desirable to continue the present form of directive with primary emphasis on financial markets while, to the extent possible, promoting growth of the monetary aggregates within the limit of the System's long-term objectives. He favored that course because open market operations in the coming period would be constrained by even keel considerations and because the Committee was not yet out of the woods of special market concerns. Thus, he preferred alternative A to B for the second paragraph of the directive. As to the first paragraph, he would suggest a small change in the sentence of the staff's draft stating that the volume of commercial paper outstanding "contracted sharply around midyear". Since the decline

apparently had continued well into July, he would revise that sentence to read that the volume of such paper "has contracted sharply."

Mr. Francis remarked that St. Louis Bank projections indicated that a fairly steady 4 per cent money growth rate over the remainder of the year would be optimal in order to achieve moderate growth in total spending and a gradual slowing of inflation. That was not significantly different from the main projections used by the Board staff in the previous month.

In his judgment, Mr. Francis continued, for the purpose of assessing the impact of System actions on the economy, rates of change in money calculated from quarterly averages were superior to calculations based on final months of quarters. The latter procedure gave greater weight to possible random disturbances in the two end-months than did the quarterly average method.

Mr. Francis said he viewed the 6 per cent rate of money growth, on a quarterly average basis, from the first to the second quarter as excessive and felt that continuation of such a rate would not be desirable. According to the blue book either alternative A or B of the draft directives would result in about a 4.5 per cent rate of expansion in money from the average of the second quarter to the average of the third quarter. Although he preferred a slightly lower rate, he would go along with such a plan. If that growth rate was not to be exceeded, it was essential that the

estimated rates of increase of under 2 per cent for August and September be considered as targets to be achieved. In his opinion, alternative B, with its greater emphasis on monetary aggregates, would more likely result in the targeted path than alternative A. Therefore, he preferred alternative B.

Mr. Kimbrel said he also had been disturbed by some of the public pronouncements of the last few weeks. In spite of even keel considerations, and in spite of various recent developments, he would like to move back to the targets for growth in the monetary aggregates the Committee had adopted earlier in the year. He preferred alternative B of the directive drafts.

Mr. Eastburn remarked that he, too, preferred alternative B. As the Chairman had pointed out, confidence had been shaken. Many people believed that, as a consequence of recent problems of confidence and of liquidity, monetary restraints had been lifted, and that the Federal Reserve would not be able to bring money and credit under control for some time to come. It was quite important for the Committee to demonstrate as rapidly as it could that such was not the case, and he thought adoption of alternative B would be helpful in that connection.

Mr. Hickman agreed with Mr. Eastburn that the need to restore public confidence in the System's ability and determination to control the monetary aggregates argued for the adoption of alternative B today.

He noted that the aggregate growth rates associated with B could be interpreted as involving a slight shift toward less restraint. As to specific language, he would favor restoring the references to market uncertainties and liquidity strains.

Mr. Sherrill said he thought the choice between alternatives A and B was a close one, although the importance of even keel considerations in the coming period made that choice less critical than it might otherwise have been. As to economic conditions, he thought there were not good grounds as yet for believing that a recovery was under way. For one thing, the better performance of real GNP in the second quarter was largely the result of improvement in the inventory situation, and it would be optimistic to expect much further improvement in the second half. For another, growth in real GNP later in the year probably would be held down by weakness in the area of capital spending.

Mr. Sherrill remarked that the interest rate declines that had occurred thus far might have been larger than was justified by the underlying situation. Rates might stop declining now, and perhaps even back up slightly, particularly in view of the large backlog of demands for funds by State and local governments and others. In his judgment that would be a healthy development, partly because further rate reductions of major proportions would lead to very rapid reintermediation and might aggravate some current problems.

Secondly, if U.S. interest rates remained stable at this point and European rates declined, the outflow of Euro-dollars would be slowed--to the benefit of the balance of payments.

For such reasons, Mr. Sherrill continued, he thought it would be best to seek stability in interest rates and money market conditions rather than to emphasize the monetary aggregates. In short, he favored alternative A for the directive. At the same time, he hoped that the third-quarter growth rate in money would neither fall below 5 per cent nor rise above 6-1/2 per cent.

Mr. Brimmer said he did not wish to encourage more rapid growth in the monetary aggregates at this point, but he was not sure which directive alternative was consistent with that position. He asked whether either alternative implied a liberalization of policy of the sort he opposed.

Mr. Partee noted that the third-quarter growth rate in money associated with both alternatives in the blue book was 5 per cent, the same rate as had been associated with the directive adopted at the Committee's previous meeting. Accordingly, it seemed reasonable to say that neither alternative involved any appreciable liberalization of policy. Perhaps he should qualify that statement because one might argue that in June the Committee had accepted a 5 per cent growth rate only as an expected consequence of the temporary objective of maintaining money market stability, and it might be said that the

Committee still had the earlier figure of 4 per cent in mind as its target for the longer run. If that interpretation was correct, it could be said that adoption today of a 5 per cent growth rate as a fundamental target would involve some liberalization of policy. It was his impression, however, that the Committee had accepted 5 per cent as its longer-run target at the June meeting.

Mr. Brimmer then said that he would favor alternative A, on the ground that its adoption would represent a renewal of the policy course agreed upon at the previous meeting. However, he thought that a reference should be retained to both market uncertainties and liquidity strains.

Mr. Treiber noted that earlier he had expressed a preference for no basic change in policy and had interpreted alternative A as consistent with such a course.

Chairman Burns asked whether there was any disagreement with the view that a reference to liquidity strains should be included in whatever directive was adopted today, and none was heard.

Mr. Maisel said he concurred in the analyses presented earlier by Messrs. Partee and Axilrod, and he would support alternative B of the draft directives. He thought the question of whether either alternative involved a "liberalization" of policy was largely a matter of semantics. As he understood the distinction,

alternative A called for holding money market rates in a narrow range, recognizing that no one could say precisely what the consequences would be for the aggregates. Under alternative B, on the other hand, the Committee would be accepting the prospect of relatively large credit flows. He thought such flows were desirable at present, and that the Committee should indicate that it was seeking them. He would not be concerned--and would not want the Desk to take any offsetting action--if the New York Bank projection for money growth in the third quarter at a 6-1/2 per cent rate turned out to be right. Such a growth rate would, he believed, be consistent with the policy posture recommended by Messrs. Partee and Axilrod.

Mr. Maisel added that he accepted Mr. Axilrod's view of even keel, which called for a relatively flexible approach.

Mr. Daane said he thought the Committee should not be contemplating any basic change in policy now, against the background of persisting liquidity strains and market uncertainties, and in light of the forthcoming Treasury financing. Moreover, he thought the present was a particularly poor time to shift away from the traditional interpretation of even keel since that would add to market uncertainties. Those considerations led him to favor adoption of alternative A, interpreted in the manner the Manager had proposed earlier. Within the framework of such an approach--

involving primary emphasis on money market rates--he would be agreeable to some shading in the direction of relaxation, as the Chairman had suggested. With respect to the draft of the first paragraph of the directive, he would favor deleting the word "some" from the statement that "some uncertainties persist" in financial markets.

After discussion, it was agreed that Mr. Daane's suggestion for the first paragraph should be adopted.

Mr. Brimmer indicated that he agreed with Mr. Daane's views on even keel.

Mr. Heflin observed that he did not favor a change in policy. On the assumption that neither alternative A nor B involved such a change, he would prefer B. The move away from a focus on the monetary aggregates had been made in light of the prevailing market turbulence. He thought this would be a good time to return to the earlier type of formulation, particularly since operations in the coming period would probably be largely determined by even keel considerations in any case.

Mr. Clay commented that there were encouraging indications that progress was being made in the battle against price inflation and that that was being accomplished within the bounds of moderate adjustment in the economy. However, he was not at all convinced that the battle against inflation had been won.

While inflationary expectations might have been dampened, they still remained very strong, as did upward pressures of wage costs on prices.

The recent high rates of growth in bank credit and the money supply were a matter of some concern, Mr. Clay continued. Part of the growth in bank credit was related to special circumstances that might be temporary, but the explanation for the money supply expansion was less obvious. Encouragement could be derived from staff projections of smaller rates of growth for the rest of the third quarter, particularly in the money supply. It was important that the rates of growth over the span of months be kept moderate. A 5 per cent rate of growth in the money supply was a little on the high side, but he was prepared to accept it. He thought, however, that care should be taken to avoid an even higher rate.

Mr. Clay suggested that, under the present circumstances, it would be desirable to return to the type of directive with primary emphasis on monetary aggregates. Thus, draft economic policy directive B would be appropriate for the period ahead.

Mr. Baughman suggested that the sentence in the first paragraph of the draft directive discussing bank credit and the money supply might be broadened to include reference to developments in early July.

Chairman Burns agreed that such a change would be helpful and suggested leaving the precise language to the staff.

There were no objections to the Chairman's suggestion.

With respect to the second paragraph, Mr. Baughman continued, the accommodative posture first adopted at the May 26 meeting had accomplished its objectives. He thought the time had come to return the monetary aggregates to the central position that they had occupied in earlier directives, as was done in alternative B. He was somewhat concerned about applying the term "moderate" to growth rates as high as 5 or 6 per cent, but he did not have another term to suggest.

Mr. Galusha said he liked the spirit and language of alternative B, but he was disturbed by the Manager's observation that under certain circumstances B might be more restrictive than A. He gathered that that view was related to the fact that the New York Bank's projections were higher than the Board's. He thought the Committee should aim for a 6 per cent money growth rate in the third quarter as a whole and he favored alternative B on that basis.

In reply to the Chairman's request for comment, Mr. Holmes said it was his impression that of those members speaking thus far who favored alternative B, roughly half preferred a growth rate of money during the third quarter on the high side of 5 per cent and half favored the low side.

Messrs. Francis and Clay indicated that they would prefer a growth rate below 5 per cent. Mr. Hickman observed that he would have favored something under 5 per cent also had it not been for the very high rate that apparently was being experienced in July. Given the July experience, it evidently would be necessary to tighten money market conditions to bring the rate for the third quarter down below 5 per cent, and he would not want to see such tightening. Accordingly, he thought the 5 per cent rate should be viewed as a floor.

Mr. Swan said he thought there was little difference in the implications for operations of alternatives A and B, given their even keel constraints and proviso clauses. However, he agreed with Mr. Heflin that the Committee had shifted to the formulation embodied in alternative A under special circumstances which were now substantially removed. He therefore strongly favored returning to the kind of formulation used in alternative B. He would not view such a directive as involving a basic change from the policy the Committee had been pursuing, since it continued to call for "moderate growth" in the aggregates. He would accept the 5 per cent money growth target as being within the range encompassed by the term "moderate", but he thought any increase beyond that would have to be slight if it were to fit that description.

Mr. Coldwell indicated that he preferred the emphasis on money market conditions contained in alternative A of the draft directives. However, he had reservations about the instruction to moderate pressures in financial markets, since he felt that had already been largely accomplished. Instead, he would suggest an instruction to "encourage stability." He saw some merit in the implication of alternative B that no significant easing was intended, but he thought A had somewhat the same connotation. Moreover, the latter retained the suggestion of some continuing market uncertainties. On balance, he would prefer his amended version of alternative A.

Mr. Morris thought the substantial improvement in market confidence that had occurred in recent weeks permitted the Committee to return to a directive centering on the monetary aggregates. Accordingly, he supported alternative B. As for money supply growth, he would prefer to err on the high side of the 5 per cent target rather than on the low.

Mr. Robertson made the following statement:

> I regard the evidence and analysis presented to us today as indicating that the economic adjustment is proceeding within acceptable bounds. Unemployment and interest rates are higher than I like, and the hoped for slowdowns in price and wage rate increases are more laggard. But I think these must be viewed as essentially the consequences of inflationary excesses that were stronger and more deeply imbedded in our economy than had been thought earlier. In these circumstances, I continue to believe that two of the most important ingredients of monetary policy are the patience and

determination to stick with our previously charted policy of moderate monetary expansion until it bears fruit in an orderly resumption of noninflationary economic growth.

With this basic policy conviction, I would like to see us move as soon as we can away from the present directive language, with its orientation to market problems, and back to the kind of more aggregate-oriented directive language we hammered out this spring.

I recognize that projecting aggregate movements is difficult during this interval because of uncertainties as to the amount of recycling of credit back through the banking system that may take place. I have no quarrel with such recycling--even though I regard it as a development that eases some financial tensions and hence is in that sense expansionary--but I would emphasize that we need to be very careful not to slip into the trap of regarding <u>any</u> size expansion in bank credit as acceptable, whether it can be directly traced to recycling developments or not. Therefore, I would urge the staff to do its best to distinguish between the amount of bank credit expansion that is essentially recycling and the amount of such expansion that represents bank earning asset increases more related to broader economic developments and credit demands. Incidentally, I found Mr. Axilrod's comments this morning particularly helpful, and I would urge the staff to continue to keep Committee members and the Desk informed on this point as bank credit increases.

I am hopeful that the path of moderate monetary expansion that I am endorsing would also carry with it some further softening of interest rates. I would like to see interest rates work lower, and I believe it is reasonable to expect some such result as the adjustment in the economy proceeds. But I would not like to see either the current level of interest rates or some lower level of interest rates accepted as a prime target of monetary policy at this juncture. I believe financial markets are now sufficiently calm so that we no longer have to be so assiduous in cushioning them from every element of pressure. Granting that we must take even keel considerations into account for most of the period between now and the next meeting of the Committee, I believe that we are well advised to take this opportunity to shift back to the kind of aggregate-oriented directive we had developed before.

> I believe alternative B for the second paragraph of the directive as drafted by the staff provides adequately for the various concerns I have expressed, and, accordingly, I am prepared to vote in favor of that alternative.

Chairman Burns noted that a small majority of the Committee members had expressed a preference for alternative B for the second paragraph of the directive. He reported that the staff had suggested a revision of the first sentence of that alternative which he thought was in accord with the discussion. It read as follows: "To implement this policy, the Committee seeks to promote moderate growth in money and bank credit over the months ahead, allowing for a possible continued shift of credit flows from market to banking channels and taking account of persisting market uncertainties and liquidity strains." The rest of the paragraph, including the proviso clause, would be as shown in the staff draft.

After discussion it was agreed that references to market uncertainties, liquidity strains, and the Treasury financing should all be included in a clause immediately following the introductory phrase "To implement this policy..."

Chairman Burns then remarked that for the Manager's guidance it would be helpful if the members would informally indicate their attitudes with respect to possible deviations from the targeted 5 per cent growth rate for the money supply in the third quarter. Specifically, abstracting from problems relating to the Treasury financing, if there were to be any deviations from the

5 per cent target would the members prefer to have them in an upward or downward direction?

In the informal poll seven members indicated that they would prefer to have any such deviations be in an upward direction, and four members indicated that they would prefer to have them in a downward direction.

By unanimous vote, 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 indicates that real economic activity changed little in the second quarter after declining appreciably earlier in the year. 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. Since mid-June long-term interest rates have declined considerably, and prices of common stocks have fluctuated above their recent lows. Although conditions in financial markets have improved in recent weeks uncertainties persist, particularly in the commercial paper market where the volume of outstanding paper has contracted sharply. A large proportion of the funds so freed apparently was rechanneled through the banking system, as suggested by sharp increases in bank loans and in large-denomination CD's of short maturity--for which rate ceilings were suspended in late June. Consequently, in early July bank credit grew rapidly; there was also a sharp increase in the money supply. Over the second quarter as a whole both bank credit and money supply rose moderately. The over-all balance of payments remained in heavy deficit in the second quarter. 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, while taking account of persisting market uncertainties, liquidity strains, and the forthcoming Treasury financing, the Committee seeks to promote moderate growth in money and bank credit over the months ahead, allowing for a possible 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; provided, however, that operations shall be modified as needed to counter excessive pressures in financial markets should they develop.

The Chairman then noted that a memorandum had been distributed to the Committee from Mr. Maisel, dated June 4, 1970, and entitled "Emergency Resolutions of the FOMC".[1/] The memorandum had been prepared in response to a question raised by Mr. Coldwell, at the March 10, 1970, organizational meeting of the Committee, regarding the applicability to foreign currency operations of certain resolutions relating to open market operations during an emergency that had been reaffirmed at that meeting. Mr. Maisel had concluded that the resolution delegating authority to an Interim Committee applied to foreign currency as well as domestic operations, but that the resolution authorizing certain actions by Federal Reserve Banks did not cover foreign operations. A possible amendment to the second resolution, consisting of the addition of a subparagraph (4), was suggested for the purpose of extending its coverage to foreign currency operations.

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

After discussion, the Committee agreed to incorporate the proposed new subparagraph in the resolution in question.

By unanimous vote, the resolution authorizing certain actions by the Federal Reserve Banks that had last been reaffirmed on March 10, 1970, was amended to read as follows:

RESOLUTION OF FEDERAL OPEN MARKET COMMITTEE AUTHORIZING CERTAIN ACTIONS BY FEDERAL RESERVE BANKS DURING AN EMERGENCY

The Federal Open Market Committee hereby authorizes each Federal Reserve Bank to take any or all of the actions set forth below during war or defense emergency when such Federal Reserve Bank finds itself unable after reasonable efforts to be in communication with the Federal Open Market Committee (or with the Interim Committee acting in lieu of the Federal Open Market Committee) or when the Federal Open Market Committee (or such Interim Committee) is unable to function.

(1) Whenever it deems it necessary in the light of economic conditions and the general credit situation then prevailing (after taking into account the possibility of providing necessary credit through advances secured by direct obligations of the United States under the last paragraph of section 13 of the Federal Reserve Act), such Federal Reserve Bank may purchase and sell obligations of the United States for its own account, either outright or under repurchase agreement, from and to banks, dealers, or other holders of such obligations.

(2) In case any prospective seller of obligations of the United States to a Federal Reserve Bank is unable to tender the actual securities representing such obligations because of conditions resulting from the emergency, such Federal Reserve Bank may, in its discretion and subject to such safeguards as it deems necessary, accept from such seller, in lieu of the actual securities, a "due bill" executed by the seller in form acceptable to such Federal Reserve Bank stating in substantial effect that the seller is the owner of the obligations which are the subject of the purchase, that ownership of such obligations is thereby

transferred to the Federal Reserve Bank, and that the obligations themselves will be delivered to the Federal Reserve Bank as soon as possible.

(3) Such Federal Reserve Bank may in its discretion purchase special certificates of indebtedness directly from the United States in such amounts as may be needed to cover overdrafts in the general account of the Treasurer of the United States on the books of such Bank or for the temporary accommodation of the Treasury, but such Bank shall take all steps practicable at the time to insure as far as possible that the amount of obligations acquired directly from the United States and held by it, together with the amount of such obligations so acquired and held by all other Federal Reserve Banks, does not exceed $5 billion at any one time.

(4) Such Federal Reserve Bank may engage in operations of the types specified in the Committee's authorization for System foreign currency operations when requested to do so by an authorized official of the U.S. Treasury Department; provided, however, that such Bank shall take all steps practicable at the time to insure as far as possible that, in light of the information available on other System foreign currency operations, its own operations do not result in the aggregate in breaching any of the several dollar limits specified in the authorization.

Authority to take the actions set forth shall be effective only until such time as the Federal Reserve Bank is able again to establish communications with the Federal Open Market Committee (or the Interim Committee), and such Committee is then functioning.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, August 18, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary's note: On July 15, 1970, the second of the two letters quoted below was sent to Mr. Elmer B. Staats, Comptroller General of the United States, over the signature of Mr. Holland. This letter was in response to Mr. Staats' letter of

June 30, 1970, quoted immediately below, to Chairman Burns.

Dear Mr. Burns:

The Chairman of the Joint Economic Committee of the Congress has asked the General Accounting Office to review the accounting standards and practices of dealers in Federal Government securities in relation to their reporting to the Federal Reserve System. A copy of the Chairman's request has been furnished to Mr. Peter Keir of your staff.1/

The Committee is concerned with the soundness of the dealers' accounting in support of the data they report to the Federal Reserve System, in the reliability and adequacy of these data, and in the accuracy of the reported profits taking into account the methods of allocating expenses. Our review is to be directed entirely to these matters through interview, interrogation and observation of dealers' activities. The knowledge and experience of officials of the Federal Reserve Bank of New York who are involved with the dealers' operations and reporting could provide valuable insight as a basis for our review approach and possibly for an entree to the dealers selected.

We plan to secure our basic data directly from the dealers and to rely on the Federal Reserve Bank of New York to validate such data from the Bank's reports and records if needed. This should avoid any question of compromising confidential data reported to the Bank by the dealers.

In view of the Committee's interest in speedy completion of our review, we would very much appreciate your cooperation in arranging with the Federal Reserve Bank of New York to assist our representatives and give them the benefit of their expertise.

Dear Mr. Staats:

I am replying to your letter of June 30, 1970, in which you asked for assistance in responding to a request from Chairman Patman of the Joint Economic Committee who asked for a review of the accounting standards and practices used by U.S. Government securities dealers in their

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1/ A copy of this letter from Chairman Patman has been placed in the Committee's files.

reports to the Federal Reserve System. It is our understanding that the General Accounting Office would secure the necessary information for complying with Chairman Patman's request by direct interviews and observation of the dealers' activities and that the necessary basic data would be obtained directly from the dealers. The Federal Reserve, notably officials at the Federal Reserve Bank of New York, would undertake to provide the GAO staff with technical advice and might in addition be asked to validate from the records of the Federal Reserve Bank of New York data which the dealers will provide.

Members of the Federal Open Market Committee, which has jurisdiction in this area, have indicated their willingness to have the Federal Reserve cooperate in this study in the manner you have outlined. It is their understanding that the confidential nature of the dealers' reports to the System would be protected and on this basis they interpose no objection to proceeding promptly with the study.

Secretary

ATTACHMENT A

July 20, 1970

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on July 21, 1970

FIRST PARAGRAPH

The information reviewed at this meeting indicates that real economic activity changed little in the second quarter after declining appreciably earlier in the year. 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. Since mid-June long-term interest rates have declined considerably, and prices of common stocks have fluctuated above their recent lows. Although conditions in financial markets have improved in recent weeks some uncertainties persist, particularly in the commercial paper market where the volume of outstanding paper contracted sharply around midyear. A large proportion of the funds so freed apparently was rechanneled through the banking system, as suggested by sharp increases in bank loans and in large-denomination CD's of short maturity--for which rate ceilings were suspended in late June. On average in June there was a moderate increase in bank credit and a slight decline in the money supply; both rose moderately over the second quarter as a whole. The over-all balance of payments remained in heavy deficit in the second quarter. 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, in view of persisting market uncertainties and taking account of the forthcoming Treasury financing, open market operations until the next meeting of the Committee shall continue to be conducted with a view to moderating pressures on financial markets. To the extent compatible therewith, the bank reserves and money market conditions maintained shall be consistent with the Committee's longer-run objective of moderate growth in money and bank credit, allowing for a possible continued shift of credit flows from market to banking channels.

Alternative B

To implement this policy, the Committee seeks to promote moderate growth in money and bank credit over the months ahead, allowing for a possible 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 forthcoming Treasury financing; provided, however, that operations shall be modified as needed to counter excessive pressures in financial markets, should they develop.