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 16, 1974, at 9:30 a.m.

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

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

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

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

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Wonnacott, Associate Director, Division of International Finance, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Assistant Adviser, Division of Research and Statistics, Board of Governors
Miss Pruitt, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Mr. Van Nice, First Vice President, Federal Reserve Bank of Minneapolis
Messrs. Eisenmenger, Boehne, Scheld, and Sims, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, Chicago, and San Francisco, respectively
Messrs. Snellings, Jordan, and Green, Vice Presidents, Federal Reserve Banks of Richmond, St. Louis, and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Ms. Tschinkel, Manager, Securities Department, 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 18, 1974, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on June 18, 1974, 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 18 through July 10, 1974, and a supplemental report covering the period July 11 through 15, 1974. Copies of these reports have been placed in the files of the Committee.

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

> The exchange markets are probably beset with more uncertainties and apprehension right now than at any time since the war. As the floating exchange rate system gradually emerged after 1970, the initial result was to open up immense and fairly predictable profit possibilities to foreign exchange traders throughout the world as Government spokesmen both here and abroad sought either to talk up or to talk down rates on their currencies. In this speculative environment, we saw a sort of hothouse growth of trading in the foreign exchange and Euro-dollar markets. Traders all over the world became increasingly reckless in the search for quick profits.
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> Since last summer, however, predicting exchange rate movements has become a highly risky affair, as market developments have been dominated by major uncertainties as to the differential impact of the oil crisis, abrupt shifts in relative rates of inflation, and varied Government responses to inflationary developments. While Government policy in most major countries has become increasingly concerned during the past year about the inflationary impact of exchange depreciation and has tended to resist such depreciation, official intervention in most countries has still not been on a sufficiently large scale to prevent a roller-coaster pattern of exchange rates; during the past year

almost every major currency has been subject at one time or another to a serious depreciation. I think we are now at a stage where the risks inherent in the floating rate system have become fairly obvious.

In this new and harsher climate, the first casualties have already begun to appear in the form of the Franklin National and Herstatt episodes, and it would not be surprising if similar situations abroad were uncovered over weeks and months to come. The closure of the Herstatt bank during the business day has had a particularly severe effect on confidence, since it pointed up to bank management all over the world that a spot foreign exchange contract could easily involve a major credit risk. Immediately following the Herstatt episode, the major banks both here and abroad instituted severe new trading procedures designed to limit their exposure, not only by sharply reducing the maximum size of transactions but also by refusing to deal with any but the very best names.

Over the past 2 weeks, we understand, the New York banks have relaxed their standards so as to provide reasonable accommodation for most of the U.S. regional banks with whom they had been dealing. The impact on Europe and Japan remains much more severe, however, with many if not most small and medium-sized banks still finding it very difficult to get the major U.S. and European banks to accept their names. Yet many of the small and medium-sized European banks probably have large forward exchange books outstanding and many have been heavily involved in Euro-dollar trading as well. In the Euro-dollar market, for example, we now see the emergence of a multi-tier rate structure; yesterday, some Japanese banks were paying 16 per cent on 3-month money, and European banks in the Herstatt class are probably encountering even greater difficulty. More generally, we see a severe contraction in the volume of trading in the spot exchange market. Commercial customers probably can still buy and sell what they need to cover their spot requirements in foreign exchange, but the forward market has almost completely dried up and in due course this could have serious effects on the flow of international trade and investment.

> During the past 3 weeks, we felt that we were confronted with an emergency situation in the exchange markets in which sharp rate movements could have further aggravated the crisis of confidence. The German Federal Bank has shared this view and both we and they have accordingly moved somewhat more promptly than before to restrain the amplitude of daily exchange rate swings. Other European central banks seem to be operating in similar fashion with useful stabilizing effects upon the whole exchange rate structure.
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> I do not mean to suggest any basic shift in day-to-day operating policies; I believe it would be appropriate to yield ground if there are strong pressures emerging in the exchange market. However, I think we have to be a bit more careful about letting these rates move very far from day to day.

Mr. Morris asked whether Mr. Coombs thought the Desk had sufficient leeway to deal with critical situations that might arise.

Mr. Coombs replied that his only concern in that regard related to the problem that would arise if the System wanted to draw on swap lines other than that with the German Federal Bank. As the members knew, the arrangement in place with the Germans would leave them to bear the full risk on any drawings they made, but called for them to share equally with the Federal Reserve any profits or losses on System drawings. A similar arrangement applied to the Belgian and Dutch lines. With respect to the other swap lines, however, the provisions for risk-bearing were not spelled out and would have to be decided upon if either party desired to draw. It might well become desirable soon to draw on the French swap line for intervention purposes--the franc had been strong recently and could become

stronger--but he thought it unlikely that the French would be willing to accept the asymmetrical arrangement in place with the Germans. Nor was it likely that the Japanese would accept that sort of arrangement. Sooner or later, in his judgment, it would be necessary to consider introducing symmetrical provisions with respect to risk-bearing in the various swap lines, although it was conceivable that the Germans would be content to have the present asymmetrical arrangement remain in effect.

> By unanimous vote, the System open market transactions in foreign currencies during the period June 18 through July 15, 1974, were approved, ratified, and confirmed.

Mr. Coombs then noted that a number of System swap drawings dating back to 1971 would mature for the twelfth time soon. They included 6 drawings on the National Bank of Belgium, totaling $230 million, which matured in the period from August 2 through 14; and two Swiss franc drawings--one of $600 million on the Bank for International Settlements and one of $371.2 million on the Swiss National Bank--which matured on August 14 and 15, respectively. There was some possibility of repaying some or all of those drawings before maturity, but since that was not assured he would recommend that the Committee authorize their renewal if necessary. Since the swap lines in question had been in continuous use for more than one year, express authorization was required for renewal

under the provisions of paragraph 1(D) of the Authorization for Foreign Currency Operations.

> By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, the Swiss National Bank, and the Bank for International Settlements, maturing in the period August 2-15, 1974, was authorized.

Chairman Burns then noted that Committee members had received a draft of a letter to the Secretary of the Treasury concerning possible use by Italy of the Federal Reserve swap line.[1/] He invited Mr. Wallich to comment on the background for the proposed letter.

Mr. Wallich remarked that Secretary Simon would return from his current trip to the Middle East--where he was visiting Egypt, Israel, Kuwait, and Saudi Arabia--via France, England, and Germany, where he expected among other things to have conversations about the balance of payments problems of Italy. The Italians, as was well known, were facing a very difficult situation; under the best of circumstances, they would require large-scale international assistance unless oil prices were reduced substantially. In his conversations, Secretary Simon was expected to take the position that

1/ The draft letter in question was transmitted to the Committee with an explanatory memorandum from Chairman Burns on July 15, 1974. Copies of the memorandum and attachment have been placed in the Committee's files.

the main responsibility for assistance to Italy lay with Germany, the richest of the nearby countries; that the U.S. share in an assistance package might be roughly proportionate to its share as a source of total Italian imports; and that if the Italians approached the United States for assistance, it would be suggested that they consult Germany first.

Mr. Wallich observed that possibilities with respect to a package of assistance had been discussed in several recent meetings of U.S. Government officials in which he, along with other System people, had participated. He had been surprised to discover in those meetings that representatives of other agencies considered the System's swap line with the Bank of Italy to be an appropriate mechanism for extending a large proportion of the credits that might be advanced by the United States. Federal Reserve representatives had repeatedly stressed that the System's swap lines were intended to be short-term facilities for dealing with forces that were expected to be temporary and reversible, not as a source of medium-term credits of the kind Italy needed to meet its oil problem. Such statements, however, had had only a limited effect; in subsequent versions of the assistance package the System's proposed contribution reappeared, although somewhat reduced.

The firm tone of the draft letter reflected that experience, Mr. Wallich observed. After stressing that swap drawings were available only for short-term purposes and not to meet medium- or long-term needs, the letter suggested that the Bank of Italy might make drawings in two $250 million tranches, each for 3 months but subject to renewals up to a year. The first tranche would be available freely but the second would be subject to certain conditions, illustrated by a reference to the condition that Italy obtain commensurate amounts on comparable terms from other parties. The letter went on to suggest that for any further drawings the Committee would expect firm take-out provisions, such as a pledge of the proceeds of prospective IMF drawings or of gold collateral.

In general, Mr. Wallich remarked, drawings by the Bank of Italy to meet its present problems would represent a use of the swap network different from the uses made in the past. At the same time, it should be noted that the System had agreed earlier this year to increase the Italian swap line from $2 billion to $3 billion; after such an action, it would be difficult to turn down a proposed drawing the first time funds were needed. Moreover, the U.S. Government unfortunately was ill-prepared to deal with the Italian crisis. The Treasury proposed to rely on the scattered sources of funds already available, including the Exchange

Stabilization Fund and the System's swap line, on the grounds that it would not be useful to recommend Congressional legislation--a course which he considered to be basically the correct one. Unless oil prices came down, other countries were likely to find themselves in situations like that facing Italy at present. Indeed, the problem of financing oil imports was likely to be a major problem in international finance.

Mr. Wallich said he thought that, while the Federal Reserve probably could not avoid participating in a package of assistance to Italy, it would be wise to limit its participation to a minimum. The role the System had played in the 1968 credit package to Britain offered some distant precedent for participating; according to the record, the Committee had agreed to extend credits to Britain despite some uneasiness about prospects for repayment. That precedent was only partial, however, because Britain's problems had arisen from a capital flow situation and thus were basically reversible. Fortunately, the British drawings were repaid quite promptly. While he might be wrong, he thought the repayment prospects in connection with drawings under the first two tranches now proposed for Italy were not as good as those in the British case in 1968. For any amounts beyond the first $500 million, protection would be provided by the firm take-out provisions called for in the draft letter. In that

connection, the pledge of gold collateral might be considered less satisfactory than the pledge of proceeds from prospective IMF drawings, since it was not clear how the System could realize on gold collateral.

Mr. Eastburn asked whether the discussions at the inter-agency meetings to which Mr. Wallich had referred in effect constituted contingency planning for the various possible emergencies that might arise, and whether an effort had been made to foresee the likely sequence of developments beyond the Italian situation.

Mr. Wallich replied that the inter-agency discussions concerning a possible package for Italy certainly constituted contingency planning. In his opinion the inter-agency discussion had anticipated even by more than needed at this time; during the course of a long conversation he had had with the Italian representative at the July Basle meeting, the latter had chosen not to take advantage of the opportunity to mention Italy's distress and its need for funds. On the contrary, he had noted that the Bank of Italy was beginning to take in foreign exchange--partly for seasonal reasons related to the summer tourist season, but partly as a consequence of the monetary measures recently taken by the Italian authorities and the expectation that the Government's fiscal measures would prove effective.

To his knowledge, Mr. Wallich continued, no extended consideration had been given by U.S. officials to where, beyond Italy,

international assistance might be needed. It would be counter-productive, in his view, for the United States to suggest that it was prepared to offer assistance to other countries encountering problems in financing oil imports. That would reduce pressures on those countries to improve their own positions, and it would reduce pressures on the oil exporters to lower their prices. Moreover, it would reduce the likelihood that the bulk of any necessary financing assistance would come from the source he considered most appropriate: the oil exporting countries. Contingency planning should be directed at developing methods other than credits from the United States for financing oil imports.

Mr. Hayes said he had understood on a visit to the Bank of Italy about 3 weeks ago that the Bank preferred to avoid external borrowing for a time while the Government was developing the needed internal measures. He asked whether that consideration still appeared to be relevant.

Mr. Wallich responded affirmatively.

Mr. Holland asked for the Special Manager's view about the likely impact on the attitudes of the System's other swap partners of Committee willingness to have the Bank of Italy draw on the swap line to help deal with its current problems.

In reply, Mr. Coombs said it seemed likely that bargaining would take place soon of the kind that had often occurred in the

past in connection with packages of international credit assistance. He was strongly in favor of the general tone of the draft letter, including the statement in the final paragraph that decisions concerning the System's swap arrangements were in the province of the Committee. The letter did suggest that the Committee would be willing to have the Italians draw $500 million on the swap line, a point Secretary Simon might well mention in his European conversations. In his (Mr. Coombs') view, it would be important to maximize the effect of such an undertaking; he would want to know, for example, what such key central banks as those of Germany, Switzerland, and Canada might be prepared to contribute to an assistance package. Past experience suggested that a better package would be developed if U.S. officials took an active part in the negotiations rather than relying on the authorities of some other country, such as Germany, to do the main negotiating.

Chairman Burns observed that Italy needed medium- or long-term money, whereas the Federal Reserve--if it held to the traditional view of its swap network, as he thought it should--could provide only short-term funds. The two $250 million tranches mentioned in the draft letter to Secretary Simon would represent only a minor part of a broad credit package. The State Department was likely to urge the System to go further; indeed, that process was

already under way. His consistent reply had been that, since the Italians needed longer-term credits and the System could extend only short-term credits, main reliance would have to be placed on other sources of funds. He had indicated that the System would play as constructive a role as possible in helping to arrange a package of medium-term credits for Italy, and that it also would help in financing the Italians for a brief period. He hoped the System would be able to hold to that position. He could envisage circumstances in which the Committee would want to bend, but he hoped it would not bend quickly or easily. In any case, he would find it easier to deal with the Departments of State and Treasury if the Committee were to support the draft letter before it.

Mr. Mitchell said he had received the impression from Mr. Wallich's comments that prospects for repayment of Italian swap drawings, particularly under the first tranche, might be relatively low. He was not sure Mr. Wallich intended to leave such an impression; in any case, he (Mr. Mitchell) thought that short-term credits should not be granted unless there was a high probability that they would be repaid, perhaps with the proceeds of medium- or long-term loans.

The Chairman remarked that Mr. Wallich's approach was probably realistic. If the Bank of Italy were to draw $500 million

on the swap line, the System might spell out its terms and conditions with utmost precision on the occasion of the original drawing and of each subsequent renewal--and still find, when a year had elapsed, that the Italians were unable to repay. There was a hazy zone in that respect from which he saw no escape.

Mr. Hayes concurred in the Chairman's comment. He added that direct lending by oil-producing countries to Italy was being considered and discussed. While he could not say whether such loans would eventuate, they were a possibility.

Chairman Burns said he personally doubted that the oil producers would make direct loans to Italy even at very high rates of interest. However, they might make such loans indirectly, through the IMF or some other international agency.

Mr. Holland said he thought one modification of the text of the draft letter would make it more expressive of the Committee's intent. Specifically, he would delete the word "freely" in the statement that "It would be appropriate for the Bank of Italy to draw, say, $250 million freely..." and to indicate by appropriate language that drawings on the first two tranches would be available in anticipation of longer-term financing to be obtained by the Italians.

There was general agreement with Mr. Holland's suggestion.

Mr. Coldwell observed that it might be desirable at some point for the Committee to consider whether it wanted to shift the basis for its swap network from a nominally short-term facility to one which contemplated longer-term credits. Such a discussion seemed warranted by the fact that some drawings, both by the System and by other parties, had proved to be of a longer-term nature. If the shift were made it would, of course, be appropriate to inform the Congress.

Chairman Burns expressed the view that such a shift would launch the Committee down a highly dangerous road. If the Federal Reserve were to abandon the principle that the swap lines were available only to meet short-term needs, there would be a natural tendency for other agencies of Government to look to the System, rather than to the Congress, for the resources to deal with a broad variety of international financial and political problems. If the System were to provide those resources it would, in effect, be substituting its own authority for that of the Congress. A decisive case could then be made in support of the charge that the System was using Federal moneys without regard to the intent of the Congress.

Mr. Wallich said it would be inappropriate on economic grounds as well for the Federal Reserve to extend long-term credits

to assist other countries in financing their oil deficits. The funds to finance those deficits were available in the surpluses of the oil-exporting countries, and they needed only to be properly channeled. The United States had already made its contribution in the form of enlarged payments for imported oil, and it should minimize further contributions--either through money creation by the central bank or through Congressional appropriations.

Mr. Mitchell commented that today's discussion would make a highly disturbing record.

Chairman Burns remarked in that connection that there apparently had been some carelessness recently with regard to the confidentiality of the Committee's deliberations. He could not stress too strongly that those deliberations were not to be discussed with unauthorized persons.

Mr. Mitchell commented that his concern was not limited to the question of confidentiality. In an environment in which private lenders and oil-producing countries were refusing to lend to Italy, he would be disturbed by a record which indicated that the Committee had agreed to extend $250 million or $500 million to Italy without any real assurance of repayment. Specifically, he was disturbed by Mr. Wallich's earlier comments on that point.

Before he concurred in the extension of such credits--and he hoped to be able to do so--he would want assurances that there was a strong probability of ultimate repayment. He would not be greatly disturbed if the credits ran on for more than a year, particularly since the Federal Reserve itself had been the beneficiary of such roll-overs in a number of cases. But a high risk of ultimate nonpayment was a different matter.

Chairman Burns said he had not understood Mr. Wallich to suggest ultimate nonpayment.

Mr. Wallich observed that he had meant only to suggest that the drawings might not be repaid within one year. His purpose had been to express properly the risks that every credit operation, and this one in particular, carried. Every effort would be made to protect the first tranche along the lines implied by Mr. Holland's suggested modification of the draft letter, so that the operation should be banker-like in character.

Mr. Holland said he hoped the proposed letter would be permitted to stand on its own in any discussion of the Committee's attitude toward credits to the Bank of Italy. In particular, he hoped no suggestion would be made that the letter should be interpreted against the background of the System's long-standing drawings on the Swiss and Belgian swap lines.

The Chairman concurred in Mr. Holland's observation.

A proposed letter from Chairman Burns to the Secretary of the Treasury, concerning possible use by the Bank of Italy of its swap line with the Federal Reserve, was approved.

Secretary's note: The text of the letter in question, which was transmitted later on the day of this meeting, is appended to this memorandum as Attachment A.

Secretary's note: A report by Mr. Wallich on the July Governors' meeting in Basle, which was distributed to the members during the course of this meeting, is appended to this memorandum as Attachment B. A report by Ms. Junz on the June meeting of the Economic Policy Committee of the OECD is appended as Attachment C.

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

Mr. Gramley presented the following statement:

Coincident business indicators suggest that there has not been much change during the past month in the generally sluggish performance of the economy described by Mr. Partee at the last Committee meeting. The industrial production figures for June were disappointing. Total industrial output did not increase further--auto assemblies stabilized and production of business equipment actually declined a little. There appears to be no major category of industrial activity showing a significant expansive thrust at this time.

The employment figures for June were a mixed bag. Total employment and the civilian labor force rose, and the unemployment rate remained unchanged. The nonfarm payroll series, however, showed a small decline on the month, mainly reflecting reductions in manufacturing and construction, due partly to strikes. Employment in these two industries is now about 275,000 below the level of last November, and the length of the workweek in manufacturing also has fallen off by half an hour since then.

Part of the recent sluggishness of economic activity can be attributed to continuing shortages--particularly of steel and coal. The steel shortage--and related scarcities in the machinery industries--are probably instrumental in holding back output of business capital equipment. Unfilled orders in the nondefense capital goods industries are enormous--almost 40 per cent above a year ago--and still rising. And revised figures becoming available since the last Committee meeting on new orders for capital goods are a little stronger than earlier estimates.

The dominant factors affecting current indicators of economic activity, however, are demand weaknesses in consumer markets and the recession in housing. In real terms, retail sales fell a little further in June--continuing the generally downward trend since the spring of 1973. Consumers are still quite pessimistic--although apparently less gloomy than they were at the height of the oil shortage earlier this year--and real spendable incomes of workers, though up a little in May, are nearly 5 per cent below a year ago.

Housing starts and permits in May were both down sharply, and starts may have dropped further in June. Judging from comments in the red book,[1/] the residential construction industry is in a serious plight almost everywhere. The multi-family market appears to be experiencing greater difficulties than the single-family market--probably because of the severe cutback in the availability and the high cost of construction financing attributable in part to the problems of the

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

REIT's. There is, however, at least one piece of favorable news about the housing market. Sales of new single-family houses by merchant builders are rising; in May, they were 24 per cent above the rate in the fourth quarter of last year, though still 14 per cent below a year earlier.

On the price side, the news continues to be most disappointing. The rise in industrial commodity prices has yet to show signs of abatement, and prices of farm products--after declining steeply during the spring months--have been rising again since the June pricing date for the wholesale price index. The wage rate acceleration of the past couple of months is particularly disturbing. We are estimating another increase in unit labor costs during the second quarter of around 12 per cent, annual rate, as productivity apparently fell further while wage rate increases were accelerating.

In our staff projection of GNP, we have had to raise once again our estimate of the projected rate of price increase between now and mid-1975. We have also lowered once again our projection of real growth, to an average rate a little below 1 per cent for the next four quarters, mainly because of the deteriorating outlook for residential building. This is quite a weak picture, but there are several reasons for believing that real expansion may prove to be even less than we now foresee.

First, our econometric model continues to project a much weaker economy than we have in our judgmental model, and we have learned from experience that the model's forecasts are worth considering. Second, our present green book[1/] GNP projection makes no allowance for the effects on savings flows of Citicorp-type security issues, and there could be serious adverse effects on housing coming from this source. Third, we have made no allowance, either, for significant downward adjustments in spending that might develop because of the growing unease in financial markets.

The implications of recent financial market developments for real activity are hard to assess. Downward

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

revisions of capital spending plans--particularly of the utilities--may already be under way, judging by the large number of cancellations and postponements of corporate security offerings in recent weeks. Tax-exempt issues have also been affected strongly. The larger concerns, however, are, first, that discontinuities in the availability of credit may be developing--for small businesses with bank loans secured by equities for which prices are collapsing, or for borrowers of regional banks having problems in rolling over maturing CD's or selling acceptances--and second, that public confidence is being seriously damaged by growing rumors of troubles plaguing commercial banks and other financial institutions.

Mr. Partee added the following observations:

As Mr. Gramley has emphasized, there are very great uncertainties surrounding any attempt to project the economy in the unusual circumstances that prevail today. Sharply rising prices are draining real consumer purchasing power, and the future performance of financial markets is a major question-mark, both here and abroad. It seems fair to conclude, however, that the main doubts all point in the direction of greater weakness in the domestic economy than is shown by our judgmental projection.

Under these circumstances, it may seem futile to attempt the rather fine policy adjustments that would promise to improve the results of the staff's judgmental projection. But since our projection now foresees a real growth rate of below 1 per cent over the next year--an outcome which would appear to be unacceptable from a public policy point of view--we have attempted to do so. Utilizing differential economic responses based on running the quarterly econometric model with alternative policy assumptions, we conclude that our judgmental projection could be lifted by about 1 percentage point in real terms--to near 2 per cent in total--by raising the assumed money growth rate to 7-1/2 per cent. On this assumption, the fixed-weight price deflator might be about two-tenths of a point higher than in the judgmental projection by the middle

> of next year, but the unemployment rate might be three-tenths of a point lower--reaching about 6.2 per cent rather than 6.5 per cent by the second quarter of 1975.
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> I know that a 7-1/2 per cent growth rate in the narrowly defined money stock will sound like a great deal to virtually all members of this Committee. Perhaps so. But the problem is that the inflation--past and present--is producing an increase in wage rates and in prices which must be financed, to a degree, if real demand is to be sustained. It is instructive to note that a 7-1/2 per cent growth rate in M_1, given the price performance that we are now projecting, would be no more than sufficient to bring the real money stock up to a zero rate of change over the next four quarters of the projection period.

Mr. Morris noted that Mr. Partee, in commenting on the possible consequences of raising the growth rate of money to 7-1/2 per cent, had considered the period only through the middle of next year. It seemed to him that a much longer time period had to be considered in order to evaluate properly the tradeoff between inflation and unemployment that would be involved in such a change in target, particularly since the lag in the effects of monetary policy actions was considerably longer for prices than for employment.

Mr. Partee agreed that a longer time period should be considered if one wanted to make a full evaluation of the price effects of a higher money supply growth rate. He might note that, according to the Board's econometric model, the difference in the price deflator under 5-3/4 and 7-1/2 per cent money supply growth

rates would grow to about nine-tenths of a percentage point by the beginning of 1976. He had referred to the implications of a 7-1/2 per cent money growth rate this morning only because the real rate of growth in the green book projection was inadequate; it seemed useful to indicate, as had been done under similar circumstances in the past, what rate of monetary growth would be consistent with a more acceptable level of real growth. He was not necessarily recommending that the Committee adopt the 7-1/2 per cent growth rate as its target; he was simply reporting that that was judged to be the money growth rate necessary to support a 2 per cent rate of growth in real GNP.

As he had indicated, Mr. Partee continued, even the GNP projection presented by the staff this morning, which suggested a rate of expansion in real output of less than 1 per cent, could well prove too optimistic. Also, at this critical stage in the development of the economy, serious problems might develop in the financial system that would in the end require an increase in the monetary growth rate considerably larger than anyone now contemplated.

Mr. Morris remarked that he had been giving a great deal of thought recently to the Committee's performance during the past few years, partly in connection with his prospective testimony

before the House Banking and Currency Committee later this week. The time horizon used in the staff projections and the Committee's deliberations was now considerably longer than it had been a few years ago. In his view, however, that time horizon was still too short, particularly because of the different lags in the impact of policy actions on employment and on prices. In general, a time frame of four quarters was inadequate as a basis for longer-run planning with respect to monetary policy.

Mr. Partee said he agreed in principle. Recently, however, as the need for longer-term projections had increased, the staff's ability to develop reliable projections even for short periods had seemed to decrease. Of necessity, projections for several years ahead would be econometric rather than judgmental in nature and he would have no great confidence in such forecasts under circumstances such as those now prevailing.

Mr. Morris observed that such projections would at least give the Committee members a framework--which they did not now have--for considering the long-run costs associated with particular short-run objectives.

Mr. Mayo remarked that he found himself in basic agreement with the staff's analysis of the outlook. However, he would question Mr. Partee's judgment that a real growth rate of less than

1 per cent would be unacceptable to the public. Until a few months ago he (Mr. Mayo) would have agreed with that statement, but it now seemed to him that a substantial body of support for inflation control had developed throughout the nation, even among those who were adversely affected by anti-inflationary policy. He thought the public at present would be prepared to accept a 1 per cent growth rate in GNP over the next year if that were required for better control of inflation.

Mr. Kimbrel asked if the staff would comment on the possibility that prices might rise at a much faster rate than projected, in light of recent large wage increases, widespread strikes, and apparently strong pent-up demands for higher wages.

Mr. Partee remarked that the staff's recent overestimates of the rate of growth in real output seemed to have been exceeded only by its underestimates of the rate of inflation. He might note, however, that the current projection of price increases allowed for a distinctly higher rate of wage advance than the previous projection had.

Mr. Gramley added that the staff had assumed an average rate of increase in compensation per manhour of a little more than 9 per cent over the four quarters of the projection period, as compared with an increase of a little over 8 per cent anticipated 4 weeks earlier.

He was not prepared to say that he had a great deal of confidence in the staff's base projection of prices. He was confident, however, that an increase from 1 to 2 per cent in the growth rate of real output would not in itself result in a price explosion; the effect on prices was likely to be quite modest.

Mr. Partee noted that the staff's price projection did not allow for the possibility of significant weakness in commodity prices. If commodity prices declined sharply, the price increase projected by the staff might be too high even though employee compensation rose rapidly. He thought the chances of an overestimate of the rate of inflation were now about the same as the chances of an underestimate.

Mr. Hayes said he agreed with Mr. Mayo that the public would be willing to accept slow growth in real output in order to achieve effective inflation control. He then asked if the staff had any observations on the long-term trend of farm prices, which seemed to have turned up again recently.

In response, Mr. Partee said the staff had not altered its earlier farm price projections for the period through 1975. The recent increase in farm prices appeared to be temporary; meat prices had risen because farmers were holding back animals, and no doubt would fall when the livestock came to market. Declining expectations

about crop yields had also contributed to the turnaround in farm prices, but ultimate crop sizes were still highly uncertain.

Mr. Gramley added that the wheat harvest still looked good, although not as good as earlier. There also had been sizable reductions in the estimated size of the corn and soybean crops. It appeared that grain prices had fallen too far and were now returning to an equilibrium level, but it was very likely that livestock prices would decline in the autumn. The staff projection allowed for a further rise in food prices at an annual rate of 4 per cent, on balance, for the year ending in mid-1975.

Mr. Hayes noted that the projections suggested a sizable advance in the unemployment rate. He asked why the staff thought that rate had been relatively stable thus far.

Mr. Gramley observed that there were two possible explanations. First, the level of real GNP might actually be higher than indicated by the published statistics. That explanation was suggested by the sharp decline in productivity implied by the published figures for the first two quarters of 1974--a decline that was about 1 percentage point greater than anticipated by the Board's econometric model. The second possible explanation was that it was a consequence of the unusually slow growth in the labor force.

Mr. Partee commented that the staff projection allowed for continued relatively slow growth in the labor force over the next year. The projections allowed for an increase of 1,300,000 persons; a normal increase over the period would be about 1,600,000 persons.

Mr. Francis noted that crop prospects in the Eighth District were mixed; the wheat crop was good, but there was an unusual degree of variation by areas in the development of corn and, to a large extent, soybeans. He suspected that Department of Agriculture estimates of corn and soybean harvests would continue to be revised downward.

Mr. Francis added that he shared the feelings expressed by Messrs. Mayo and Hayes about the greater willingness of the American public to accept the hardships necessary to control inflation. He realized that Mr. Partee, in referring to a 7-1/2 per cent money growth rate, was not recommending that as a target but, rather, was describing the money growth he thought necessary to achieve an acceptable rate of growth of real output. However, in view of the indications of continuing shortages that he (Mr. Francis) found both in the red book and in conversations with businessmen, he was concerned that such a rate of growth in the money stock would simply confirm expectations of gradually growing inflation.

Mr. Eastburn remarked that the forecast prepared at the Federal Reserve Bank of Philadelphia was quite similar to that presented by the Board staff. Although the Philadelphia projection suggested somewhat more real growth in 1975, he would not put much weight on the difference. However, the Bank model yielded consistent increases in both short-term and long-term interest rates. If one allowed for the lagged effects of recent rapid monetary growth on future prices and the associated inflation premium, it would appear that interest rates would rise even more.

Mr. Partee noted that the staff's judgmental projection suggested gradually rising interest rates, both short-term and long-term, into 1975; its econometric model yielded even higher rates over that period. Given the expected large rise in prices and therefore in nominal GNP, a moderate money supply growth rate would require a sizable increase in velocity, with consequent upward pressure on interest rates. On the other hand, if money were to grow at a 7-1/2 per cent rate, the bill rate--which was now out of line with the other market rates--might hold fairly steady over the projection period at about 8 per cent, slightly above the current level. In general, the higher rate of growth in the money stock would moderate the rise in interest rates in the short run.

Mr. Eastburn observed that, presumably, even with a 7-1/2 per cent increase in money supply, the rise in interest rates would resume in future years because of the inflation premium.

Chairman Burns remarked that a continued rise in long-term interest rates would have disturbing implications for the economy. Under such circumstances, very high price levels would be required to enable capital-intensive industries to meet fixed interest charges and to continue to function.

In reply to a question by Mr. Winn, Mr. Partee said one of the assumptions underlying the staff's projection was that funds would be appropriated for a large public employment program, involving about 230,000 persons. If the rate of unemployment were to rise sharply, the Government might institute an even larger program. As yet, however, not even the program assumed had been funded.

Mr. Winn asked whether it would be better to urge Congress to move forward with such programs rather than accepting the defeat in the battle against inflation that would be implied by adopting a 7-1/2 per cent target for the growth rate of money.

In response, Mr. Partee said he would not consider a temporary step-up in the target growth rate for M_1 to be a defeat. Perhaps he should have answered Mr. Eastburn's question more fully by noting that, even if the money supply were to increase at a

7-1/2 per cent rate, the rise in real output would not be fast enough to press against the economy's gradually growing capacity. The annual rate of growth of real GNP would continue to edge up throughout 1975, but since it would not be likely to exceed 3 per cent the rate of inflation should tend to subside over the period. Of course, if the expansion of the money stock were to continue at 7-1/2 per cent indefinitely, the rate of inflation would eventually rise. It would be reasonable to expect, however, that the target growth rate for the money supply would be reduced as the rate of inflation--and the rate of increase of nominal GNP--slackened. In short, it should not be impossible to work out a strategy that would both slow inflation and maintain minimal real growth in the economy.

The Chairman observed that the whole question was complex and difficult. One could envision circumstances under which, as the rate of inflation intensified, even partial accommodation of the more rapid growth of nominal GNP would require letting the money supply rise by more than 7-1/2 per cent.

Mr. Gramley noted that there had been a number of comments about the willingness of the public to accept a 1 per cent growth rate in real GNP for the sake of controlling inflation. In his opinion, however, the real issue was whether aiming for such a low rate of growth would entail a significant risk that the

economy might slide into a recession. If that occurred, there undoubtedly would be strong pressures for relaxation of both monetary and fiscal policy.

Mr. Mayo expressed the view that that risk would be almost as great if the Committee aimed for a 2 per cent growth rate in real GNP.

Mr. Mitchell observed that he believed the situation had come to an impasse of sorts. There were widespread reports of shortages, but the ability of business decision-makers to deal with the shortages by expanding capacity was being impeded by high interest rates. In the past 4 weeks alone, about $2 billion of long-term debt offerings had been postponed or withdrawn, apparently because rates were too high. Many businessmen evidently were not willing to finance in the capital market at prevailing rates because they expected the rate of inflation to slacken and interest rates to decline. To the extent that high interest rates were causing postponement of capital improvements, monetary policy was frustrating the improvement of supply conditions that was essential to economic recovery.

Mr. Mitchell then said he expected that the Committee members who were scheduled to appear at the House Banking and Currency Committee hearings would find that members of that Committee, at least, did not share the view that the American public would accept a 1 per cent growth rate for real GNP.

Chairman Burns remarked that he had received a different impression in his appearance before the House Ways and Means Committee yesterday. He had expressed his view that little or no economic growth could be expected for some months, and that that outlook should be accepted as a matter of policy under present circumstances. None of the members of the Ways and Means Committee, not even the more liberal members, expressed any shock or criticism. More generally, in his many recent conversations with Congressmen he had found widespread acceptance of the need for slow economic growth; they reported that their constituents were more anxious about inflation than about unemployment.

In reply to a question by Mr. Sheehan, Mr. Partee said that in the judgmental model the assumption of a 5 per cent money growth rate would result in a real growth rate of about zero.

Mr. Sheehan noted that that would entail an even greater risk of recession than implied by the green book projection. He asked about the probable near-term effects of a 5 per cent money growth rate on disintermediation.

In response, Mr. Partee observed that some increase in disintermediation would be expected because interest rates would remain high for a time. In addition, that problem would be compounded by the issuance of floating-rate notes such as those proposed by Citicorp.

In reply to a question by Mr. Morris, Mr. Partee said that the judgmental projection called for housing starts to remain stable at about 1.5 million units through the end of 1974 and to drift down next year--to 1.4 million units by the second quarter of 1975. There was, of course, a real risk that starts would fall substantially faster.

Mr. Wallich asked if the upward revision in the projected increase in compensation per manhour was reflected in a proportionate rise in consumption in the staff's judgmental model.

Mr. Gramley replied that the projection of disposable income had been increased on that ground, and the increase had tended to raise projected consumption expenditures. However, because current data suggested a lack of consumer willingness to spend, the saving rate was projected to remain at around 6-1/2 per cent.

Mr. Wallich noted that a 1 per cent addition to the rate of advance in employee compensation amounted to about $8 or $10 billion. Such a large amount of money should result in a considerable improvement, either in savings flows or in consumer spending.

Mr. Partee observed that an $8 to $10 billion increase in income would amount to less than the drain on real income resulting from the oil price increases of last winter.

Mr. Wallich then asked whether the continuing rise in industrial prices was still predominantly a demand-pull phenomenon, resulting from shortages and bottlenecks, or whether cost-push factors were now predominant.

Mr. Partee said there was reason to believe that the rise in prices of manufacturers' industrial materials was primarily cost-push; with the ending of controls, firms had been attempting to restore profit margins. He thought it was unlikely that the recent abnormally high rate of increase in industrial commodity prices would persist.

Raw materials prices, Mr. Partee continued, had shown some tendency to slip in recent months; on balance, the Federal Reserve commodity price index had moved down since early April. The decline had not been large, however, and there appeared to be sufficient demand for the time being, perhaps resulting from inventory stocking, to maintain raw materials prices at close to current levels.

Mr. Wallich remarked that he would feel uncomfortable with a real growth rate as low as 1 per cent. While he was prepared to incur some risks in the interest of achieving the Committee's objectives, that rate was close to the brink. He would prefer a growth rate about half way between zero and the economy's potential. He thought, however, that other forecasters on balance

expected economic growth to be somewhat stronger than the staff projection, and he personally felt that there was good reason for that expectation. In particular, it appeared to him that the staff projection was unduly influenced by the assumed growth rate of the narrowly defined money stock; he noted that some of the other monetary aggregates were expected to be stronger than M_1.

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 18 through July 10, 1974, and a supplemental report covering the period July 11 through 15, 1974. Copies of both reports have been placed in the files of the Committee.

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

> There was a sharp deterioration in financial market conditions, both domestic and international, over the period since the Committee last met. An excess of investor caution virtually dried up the capital markets and a further move towards selectivity played havoc with the money market. The viability of individual banks was called into question by many observers, a few large industrial firms dropped CD's completely from their investment portfolios, and most investors became still more reluctant to purchase CD's issued by any but the top banks. There was also some evidence of a deposit shift from regional to money market banks.
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> REIT's and utility firms found it increasingly difficult to borrow in the commercial paper market and some bank holding companies found themselves in

the same unenviable position. The acceptance market was faced with a substantial supply of bills and had its own problems as the withdrawal of a major acceptance dealer from the market forced many smaller banks to seek new outlets. Interest rates--except for Treasury bills--rose sharply in almost all sectors of the market, leading to new fears of disintermediation. The inability of some borrowers to find funds in the market at any price forced many of them to take down lines at their commercial banks, increasing pressure on the latter to seek funds.

In this atmosphere, banks became very cautious. This attitude first became apparent around the June statement date and has continued ever since. Despite the exceptionally high Federal funds rate, banks were reluctant to come to the discount window, presumably hoping to keep their record clear for even rainier days. In fact, on several days last week, special borrowing at the window by the beleaguered Franklin National Bank exceeded the borrowing of all other member banks in the country. The actual average level of borrowing fell sharply below the anticipated $2 billion figure, creating a need for the Desk to add to nonborrowed reserves to make up for the shortfall in borrowing at the window.

Despite concerted action by the Desk to carry out the Committee's instructions, including those arising out of the July 5 telephone meeting and the Chairman's recommendation included in the telegram of July 10, we have not yet been able to bring the funds rate all the way down. Reserve-supplying operations have been large and have taken place on every working day. Given the long-run nature of the reserve need, we would have preferred to do more outright buying than was actually the case. But the shortage of securities, particularly in the Treasury bill area, proved to be a real, and disturbing, constraint. As it was, we purchased in the market $900 million of Federal agency issues in three go-arounds, $175 million of Treasury coupon issues, and only $289 million of Treasury bills. RP's had to be our standby, and these came to a total of about $11 billion--a very high figure.

Our frequent appearance in the market--and the low level of bank borrowing--led a few market observers to conclude that the System is in process of abandoning its tight monetary policy. Others, looking at the high level of the Federal funds rate and of borrowing costs, have concluded that the System has tightened its policy since the last meeting, despite the relatively good behavior of M_1 and M_2. All of this just adds to the confusion in the market, which was already ample. There are still others who believe that System policy is basically unchanged but that the current psychological state of the markets makes interest rate relationships completely unpredictable if not completely unintelligible. I should note that foreign transactions were sizable during the period, involving System purchases and sales that about offset one another--until yesterday, when we were able to buy over $200 million of Treasury bills from foreign accounts. One transaction involved the purchase of $129 million short-term Treasury bills from foreign central banks and the sale of a like amount of longer-term bills to an oil-producing country to complete the large order that was mentioned at the last Committee meeting. Today we will be investing $400 million for another oil-producing country, but expect that the Treasury will be taking care of part of the order by issuing special securities.

Looking ahead, our reserve estimates indicate a need to supply reserves in the next two statement weeks. We shall endeavor to make substantial additional outright purchases of securities. But dealers are still in a net short position in Government securities and availability is not likely to be great, particularly if foreign buy orders are large. There is an availability of agency issues and bankers' acceptances, and we plan to buy both, although the amount that can be done in acceptances is limited--particularly on a day-to-day basis. We shall again, undoubtedly, have to rely heavily on RP's. If it appears likely that we will be unable to provide reserves in the desired amount because of collateral shortages, we will so inform the Chairman. Contingency planning is obviously the order of the day.

> As far as the Treasury is concerned, it has just announced a $1.5 billion, 9-month note issue by the Federal Financing Bank, that institution's first issue. Since the Committee has decided to treat FFB issues in the same way as Treasury issues, the same even keel considerations should apply to the FFB as to the Treasury. Since the securities in this particular issue are short-term and will be sold at auction, no problems appear to exist. Later this month the Treasury will announce the terms of its August refunding of $4.4 billion publicly-held maturing issues. Even keel considerations should prevail for that financing, although even keel is hard to define in these parlous days. The Treasury expects to raise about $7 billion in new money between now and mid-September, but concrete plans have not yet been finalized. Actual Treasury needs will depend on how many special issues will be made to foreign monetary authorities, particularly those of oil-producing countries.
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> It is somewhat ironic that strenuous efforts are being made to attract oil money to our markets at a time when both our money and capital markets are in disarray. There is some consolation in the fact that domestic financial markets abroad and the Euro-markets are also in disarray. A return to greater stability in our financial markets would obviously be a matter of great significance for the entire world financial system. In this respect, it is equally obvious that we must continue to remain alert to developing circumstances in all the financial markets and be prepared to act as best we can in response to any new development.

Mr. Bucher said he understood that supply constraints were the factor limiting the Desk's outright purchases of Treasury bills and bankers' acceptances. He asked about the extent to which outright purchases of agency issues and Treasury coupon issues were being limited by similar technical considerations of availability, as opposed to judgments by the Manager regarding the possible

effects of additional purchases of such securities on market psychology.

In reply, Mr. Holmes remarked that the limitations on outright securities purchases in the recent period were primarily technical in nature. With respect to Treasury bills, the problem was wholly one of availability. To illustrate, one day last week the Desk had encountered great difficulty in executing foreign account orders to buy $70 million of bills--a small amount by normal standards. In the bankers' acceptance market, the problem was not one of reduced availability but rather of the nature of the market; it simply was not possible to trade in large blocks. It was feasible, however, to buy a substantial volume of acceptances over a period by acquiring relatively small amounts from day to day. Agency securities could be acquired in volume; as he had noted, $900 million had been purchased in the 4 weeks since the last Committee meeting.

The availability of Treasury coupon issues was more limited, Mr. Holmes continued. The Desk was particularly alert to opportunities to acquire coupon issues from dealers who, while holding no inventories of their own, did have sell orders from customers wanting to liquidate their holdings. He might note that banks recently had liquidated a smaller volume of Treasury issues than

he had expected; they had found it preferable to use their holdings as collateral on repurchase agreements.

Mr. Mayo asked whether it would be correct to infer from Mr. Holmes' remarks that the Treasury had resolved any questions it might have had earlier with respect to the desirability of permitting oil-producing countries to invest their revenues in special Treasury issues.

Mr. Holmes replied that the basic decision to proceed with such issues had been made. However, a number of details remained to be worked out.

Mr. Mayo then asked about the likely spreads between the yields on issues of the Federal Financing Bank and those on other market securities. He noted that one of the advantages anticipated from the establishment of the Bank was that its securities would be viewed by the market as more similar in character to Governments than to agency issues.

Mr. Holmes remarked that, in general, he would expect the yields on FFB securities to be closer to those of Governments than to agencies of comparable maturity. Given the current state of financial markets, however, there was some uncertainty about the performance of the initial FFB offering. On balance, he thought it probably would perform quite well, particularly in light of the strong demand for short maturities.

Mr. Morris said he was concerned about the possibility that over the longer run the System's ability to supply reserves in the amounts desired would become increasingly impaired by the restricted availability of securities in the market. The System had made no significant change in its reserve-supplying techniques for a number of years; one proposal to be considered later today--to increase the authorized holdings of bankers' acceptances--would be constructive, but it was quite limited in scope. He thought it would be desirable to have a staff committee appointed to consider possible new means of supplying reserves to the market.

Chairman Burns remarked that the study Mr. Morris had proposed might be combined with an examination of the extent to which the Desk's problems would be alleviated by a change in the mix of Treasury issues.

After further discussion, it was agreed that a staff committee should be appointed for the purposes mentioned.

> Secretary's note: On July 18, 1974, the Committee was advised that Chairman Burns had named the following to serve on the indicated staff committee: Mr. Holmes, System Account Manager; Mr. O'Connell, General Counsel; and Mr. Axilrod, Economist (Domestic Finance), Chairman.

Mr. Black said he had been interested to note in the green book that for the first time the staff had reliable reports that Arab oil proceeds were being placed in market investments other

than Treasury bills. He asked what such investments might imply for rate pressures on CD's, bankers' acceptances, and other such securities.

Mr. Holmes replied that, while he had no firm information on the volume of oil revenues being invested in various types of private securities, such investments thus far did not appear large enough to have a significant impact on relative interest rate levels.

Mr. Eastburn noted that in earlier discussions of the causes of the rise in the Federal funds rate to levels above 13 per cent, a good deal of stress had been placed on technical factors. He asked whether those factors were thought to explain the continuing high funds rate or whether some more basic forces appeared to be at work.

Mr. Holmes expressed the view that the original upsurge in the funds rate had been touched off by developments related to the end-of-June bank statement date and the Fourth of July holiday. In explaining the persistence of the high rate, however, he would lay greater stress on attitudes in the market, including the willingness of many banks to pay extremely high rates for funds in order to avoid borrowing at the discount window.

Chairman Burns asked whether the difficulties being experienced by some banks in rolling over or expanding their outstanding CD's were not also a contributory factor, and Mr. Holmes responded affirmatively.

Mr. Balles remarked that on the basis of his own commercial banking experience he could fully understand the reluctance of many large banks--even those with severe liquidity problems--to use the discount window at present. Since they did not know how long the present degree of monetary restraint would continue, it was reasonable for them to want to preserve their rights of access to the window for possible use at a time when the need might be even greater. In the meantime, they were willing to pay a very high rate for Federal funds. From the standpoint of the Federal Reserve, however, the approach those banks were following was counter-productive; in particular, it aggravated the Desk's difficulties in attempting to achieve the Committee's reserve objectives while also keeping the Federal funds rate within the targeted range. That led him to wonder whether it might not be desirable for the System to inform the banks--particularly those that were encountering serious difficulties in rolling over CD's and in acquiring Federal funds--that it was prepared to relax its standards for borrowing a bit, both in terms of the maximum amounts that might be borrowed in any given week and the number of weeks for which borrowings might remain outstanding. It would be unfortunate, in his judgment, if the member

banks were permitted to believe that the System's usual ground rules for adjustment credit would prevail throughout a period of near-crisis conditions, even though increased use of the window would offer positive benefits in alleviating the Desk's problems in providing reserves.

Mr. Hayes observed that he also had been wondering whether it might not be desirable to encourage some additional member bank borrowing. He was not sure, however, that it would be necessary to make any change in the System's rules; at least in the Second District, most banks had ample leeway to borrow under the existing rules.

Mr. Coldwell noted that when the System had followed such an approach on a previous occasion, only one member bank in the country had responded. He understood that that bank--which happened to be located in the Eleventh District--had later regretted its action.

Mr. Holland remarked that on the occasion referred to by Mr. Coldwell, the System had not limited itself to offering assistance at the window; it had restricted the types of loans that could be made by banks accepting that assistance. In retrospect, he believed the approach followed then had not been the best. More generally, there were several different ways in which the Federal Reserve might

pursue the objective of having a somewhat higher proportion of bank reserves provided in the form of borrowings. He might mention that questions of that kind would be considered by the new "Discount Policy Group", chaired by Mr. Axilrod, which had been established in connection with the reorganization of the Board's staff management functions announced today.

Chairman Burns observed that it might be possible to achieve the results Mr. Balles sought without precipitating an avalanche of borrowing by having Reserve Bank officials in each District ask member banks about the reasons for the low level of borrowings.

Mr. Francis commented that such a procedure might appear strange to banks that had recently been asked to terminate their borrowings.

Mr. Winn said he also would see problems with the suggested procedure in light of the current level of the discount rate relative to market interest rates. Encouraging banks generally to borrow more could be interpreted as rewarding those that had been operating aggressively. He might note in that connection that two nonmember banks in his District had applied for access to the window last week not because they were in difficulty but simply because they found the rate so attractive.

Mr. Winn then referred to the Manager's comment that dealers were still in a net short position in Government securities, and asked whether Mr. Holmes found that situation disturbing. He also asked who was responsible for policing the Government securities market.

Mr. Holmes replied that the current short positions made open market operations more difficult than they otherwise would be. From a different point of view, he was concerned about the large number of due bills issued by banks, not all of which would be reflected in the available statistics. The problem of due bills might be resolved by a proposed regulatory measure the Board had published for comment. On the second question, while there was no formal assignment with respect to policing the market, informally he considered that to be part of his responsibility.

Mr. Axilrod added that that function also was performed to some extent by the joint Treasury-Federal Reserve staff committee on the Government securities market which had been in existence for a number of years.

Mr. Holmes said he might report that the Federal funds rate had finally dropped below 13 per cent; according to information he had just received, it was now trading at 12-1/2 per cent. He should add that one swallow did not make a summer.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 18 through July 15, 1974, were approved, ratified, and confirmed.

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

As you can see from the blue book,[1/] the staff expects that the funds rate would need to drop back to around the 12 per cent area if money supply growth is not to fall short of the Committee's longer-run desires as expressed at the last meeting.

Many factors, of course, influence the relationship between money growth and interest rates, in particular the Federal funds rate. Special influences driving the Federal funds rate up to the 13-1/2 per cent level over the past few weeks have been noted in the documentation presented to the Committee and by the Manager in his report this morning. There is no need for me to repeat all of these. But I do want to highlight the reasoning that lies behind our view that the rate would probably decline if the Committee were to stay on its longer-run path adopted at the last meeting.

The basic reason is that we believe the upward move in the funds rate in good part reflected a downward shift in banks' willingness to supply money to the public and not an upward shift in the public's demand for money. Such a downward shift in the supply function would manifest itself in a reduced willingness to borrow from the Federal Reserve by banks and an increased tolerance for excess reserves for a given level of the Federal funds rate. Last week member bank borrowing, other than emergency borrowing, had

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

declined to only about $1-1/4 billion, a level that last spring was associated with a funds rate of around 10 per cent. Excess reserves, too, were running above spring levels. This means that reserves supplied by open market operations were being absorbed by banks' increased demand for free reserves and were not, therefore, available to support bank credit and deposit growth.

I very much doubt that member banks' demand for borrowing from the Federal Reserve at a given funds rate has been permanently reduced, however. Discount officers on a conference call late last week did report that many large city banks had indeed been making it a policy to stay out of the window recently, but the officers thought this was mainly an effort by banks to attain a clean record so as to insure access to the window in case of even more stringent liquidity pressures later. Nevertheless, so long as demand for borrowing is reduced, given the funds rate, the Desk would have to increase its reserve-supplying operations in order to prevent total reserves from falling short.

Provision of more reserves through open market operations and consequent stabilization of the funds rate would, of course, be inappropriate if the underlying trend in demands for money and credit were changing. For example, under current circumstances, if the recent sharp rise in the funds rate reflected a strengthening of GNP and associated transactions demands for money--or if there were increased precautionary demands for cash by the public--stabilization of the rate at about 12 per cent would lead to greater expansion in bank reserves and more money growth than the Committee desired. We have no evidence, however, of such a strengthening in GNP; staff estimates on the contrary have been moving toward greater weakness. And M_1 in recent weeks at least has been on a plateau, showing no growth from the beginning of June to early July.

Providing more reserves to keep the funds rate from rising would also be inappropriate if the rise in the funds rate merely reflected a restructuring of the yield curve in short-term markets--with one-day rates rising and other rates falling. This could happen if market participants thought a climax in

credit market pressures was at hand; borrowers would attempt to keep their liabilities as short as possible in an effort to reduce interest costs over time. Banks, for example, would tend to borrow in the Federal funds market rather than by issuing CD's.

There has probably been some focusing of interest rate pressures on the overnight market during the past week or two as fears of financial difficulties have become somewhat more widespread, partly in the wake of the Bank Herstatt failure, and risk premiums have become much larger in credit markets. Some regional banks appear to be experiencing difficulty in rolling over CD's and in the short run they would have to turn to the funds market; they probably would be willing to pay something of a premium rate in that market.

While some of the recent rise in the funds rate does reflect increased uncertainties in financial markets and views that a climax may be near at hand, the exact chain of cause and effect is not totally clear. The rise in the funds rate and its persistence at around 13-1/2 per cent has also influenced market attitudes and other short-term rates. As a result, other short-term rates, apart from Treasury bills, have moved up into closer alignment with the high funds rate. In other words, rather than simply reflecting a reshaping of the yield curve, the high funds rate has recently been pulling the whole short-term rate structure upwards.

In conclusion, my assessment of the evidence suggests that the recent rise in the funds rate reflects a reduction, probably temporary, in member banks' willingness to borrow. It may also reflect other adjustments being made more generally as liquidity pressures mount, but we are not seeing any compensating decline in other rates as one might expect if pressures were being transferred to the funds market. The rise in the funds rate does not appear to reflect a strengthening of credit and money demands. Thus, if and as the high funds rate leads to a persistently higher short-term rate structure, monetary restraint will become more intense.

Mr. Mitchell asked about the effects of the recent large international flows of funds on domestic interest rates and on the degree of tightness in domestic money markets.

In reply, Mr. Axilrod observed that Treasury bill rates had been depressed relative to other rates by, among other things, bill purchases for foreign official accounts. Also, uncertainties in the Euro-dollar market resulting from the Bank Herstatt failure no doubt had contributed to the rise in the Federal funds rate around the time of the end-of-June bank statement date, by affecting market psychology and perhaps also by leading to some temporary diminution in the availability of Federal funds through foreign agencies and branches. However, he did not believe that the persistence of the high Federal funds rate could be explained in terms of international developments. And while international flows of funds had clearly affected the structure of domestic interest rates, he did not believe they had any necessary consequences for the average level of domestic rates so long as the Committee remained willing to pursue particular objectives with respect to bank reserves and money. While others might disagree, he would not attribute any significant part of the current money market tightness directly to recent international flows.

Mr. Mitchell then asked about the sources of the Treasury bills that had been purchased recently for foreign official accounts.

Mr. Axilrod replied that some of those bills had been supplied from the System's portfolio. He had no information at the moment regarding the ultimate suppliers of the remaining bills that were bought in the market through dealers. The staff was now making a longer-run assessment of changes in ownership of Treasury debt which might throw some light on that question.

Mr. Holmes remarked that a substantial volume of the bills the dealers had acquired in recent weekly Treasury auctions had been resold immediately to foreign official accounts.

Mr. Coldwell asked if the staff would comment on the effects on M_1 of shifts of funds between foreign official balances and Treasury balances, such as might arise from the purchase of special Treasury securities for foreign official accounts.

Mr. Axilrod replied that staff members had debated questions of that type over the years without reaching a consensus. Personally, he thought such transactions had no significant lasting effects on M_1 because they did not reflect a shift in money demand, given interest rates. Ordinarily, the bulk of the funds originally transferred to the foreign accounts would probably have been raised by liquidating investments in market securities, rather

than by reducing money balances. Private deposits would be reduced in the process of effecting the transfer of funds. The funds would pass through foreign deposits and would then lodge in Treasury balances if the foreigners invested in Treasury specials. Such an increase in the Treasury balance would reduce the need for Treasury cash borrowing--or permit the Treasury to repay market debt--and that would in effect return cash to the market, as would occur more directly if the foreign account itself bought securities in the market rather than from the Treasury.

Mr. Mitchell noted that, depending on the nature of the transactions, the outcome could be affected by the fact that the money stock was defined to include foreign official deposits. He asked about the justification for such a definition.

Chairman Burns remarked that that question was a technical one which could lead to extensive discussion. While he was dubious about the desirability of defining M_1 to include foreign official deposits, he thought the Committee should not take the time to debate the matter now.

Mr. Winn noted that the growth rates of other monetary aggregates had been higher than that of M_1 over the first half of 1974, apparently as a result of a shift toward money substitutes. He asked whether the Committee should not be taking greater account of the paths of those aggregates rather than focusing primarily on M_1.

In reply, Mr. Axilrod remarked that the first-half growth rates of M_2 and M_3, while still above that of M_1, had dropped considerably from the average of the three preceding years, whereas the M_1 growth rate had not. That pattern was expected to persist over the second half of the year; under alternative B, for example, the growth rate of M_2 was expected to be only about 1 percentage point higher than, and that of M_3 about the same as, the growth rate of M_1. As he had indicated at the previous meeting, restraint was now focused more on M_2 and M_3 than it had been in past periods of tight money.

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

Mr. Hayes remarked that the principal change in recent weeks seemed to him to have been an increase in the degree of unease in domestic and international financial markets. Obviously, the strained state of those markets and the possibility of further failures posed very real risks at this point. Nevertheless, he thought the battle against inflation might be entering a critical stage also. It had been apparent all along that a monetary policy capable of bringing that fight to a successful conclusion would entail risks. It now appeared that it would be necessary to live with those risks for some time to come. The problem would be to avoid going beyond prudent limits of restraint.

Mr. Hayes said he thought it was clear that the Committee had to focus its attention on money market conditions at this time. With regard to the aggregate targets, however, he would prefer to hold to the moderate growth rate objectives the Committee had set for the second half of the year. He recognized that it might be impossible to maintain sufficient pressures in the financial markets to achieve those objectives. For the present, however, he would retain the existing longer-run targets of 5-1/4 per cent for M_1, about 6 per cent for M_2, and 9-1/4 per cent for the bank credit proxy. The 5-1/2 per cent M_1 target shown in the blue book under alternative B also would be acceptable to him. As to the July-August tolerance ranges, 3 to 6 per cent for M_1 and 5-1/2 to 7-1/2 per cent for M_2--which were reasonably close to the ranges shown under alternative B--would be acceptable.

The more difficult, and more pertinent, questions related to the range for the Federal funds rate, Mr. Hayes observed. Rates averaging at or close to 13-1/2 per cent over the past 2-1/2 weeks were clearly well above what the Committee had intended. He would not add to the comments already made on the reasons for the recent high funds rate, but he would note that it remained desirable to try to get that rate back to something closer to what the Committee had had in mind at the previous meeting. Given the prevailing conditions in the market, there was no easy formula for doing that;

it would be necessary to give the Manager an unusual degree of discretion at this time. He would suggest a range of 11-1/2 to 13 per cent, with the understanding that the Manager would seek to nudge the rate back to the 12 to 12-1/2 per cent area if market conditions made that at all possible. He would use the relatively high upper limit of 13 per cent to avoid forcing an undue volume of reserves on the market if the special factors that had produced the high rate should persist.

As for the directive, Mr. Hayes observed, he preferred an operational paragraph couched in terms of money market conditions in place of the staff's alternatives.[1/] He would suggest the following language: "To implement this policy, the Committee seeks to maintain restrictive money market conditions while taking account of the unusually sensitive conditions prevailing in domestic and international financial markets, the special factors that have affected the markets for bank reserves in recent weeks, and the forthcoming Treasury financing."

The Chairman remarked that there was much to be said for Mr. Hayes' language. However, he would prefer a final clause reading "while taking account of the sensitive conditions prevailing in financial markets and the forthcoming Treasury financing."

Mr. Hayes said that revision would be acceptable to him.

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

Mr. Mayo expressed the view that the degree of monetary restraint in place was just about right, given the complications in the present situation. Despite his earlier comment regarding the willingness of the public to accept slow economic growth to achieve some lessening of inflation, he would not want to see any increase in restraint. He was almost completely in accord with the specifications shown under alternative B; in particular, he thought an M_1 target growth rate of 5-1/2 per cent for the second half of the year would be consistent with the Committee's previous policy stance and with good--although not perfect--inflation control over the remainder of 1974.

About the only modification he would make in the alternative B specifications, Mr. Mayo continued, would be to widen the short-run ranges of tolerance for growth rates in the July-August period. As he had indicated at other recent meetings, he considered a 2 percentage point range too narrow. Thus, he would prefer a range of 2 to 6 per cent for M_1 growth in July-August, in place of the 4 to 6 per cent range shown in the blue book. He would have no problem in accepting the range of 11 to 13 per cent shown for the Federal funds rate under alternative B, particularly since the rate had declined into that range today. For the directive, he would prefer the language of alternative B to that suggested by Mr. Hayes.

Chairman Burns noted that neither Mr. Hayes nor Mr. Mayo favored an intensification in the degree of restraint at this time, and neither favored an easing of policy. He concurred in those views. In order to provide a focus for the discussion, he might suggest some possible specifications for the members' consideration. For the longer-run M_1 target, he proposed retaining the 5-1/4 per cent growth rate for the second half of the year that the Committee had agreed upon at its previous meeting. For the July-August ranges of tolerance, he suggested using the upper limits shown under alternative B but reducing each of the lower limits somewhat. Specifically, the ranges would be 2 to 6 per cent for M_1, 4-1/2 to 7-1/2 per cent for M_2, and 8-3/4 to 11-3/4 per cent for RPD's. For the Federal funds rate, the range would be 11-1/2 to 13 per cent.

Mr. Francis said he would find acceptable either the specifications for the aggregates shown under alternative B or those proposed by the Chairman. As he had often noted in the past, he favored reducing the emphasis placed on the Federal funds rate. It was his impression that the markets had adjusted better than many would have expected to the higher funds rate levels that developed in recent weeks, and his present inclination would be to focus solidly on the aggregates and let the markets adapt to whatever funds rate emerged.

Mr. Morris asked how the Manager would expect to implement specifications along the lines of alternative B.

In reply, Mr. Holmes noted that the Desk's most recent objective had been to bring the funds rate down to 13 per cent, and to permit the rate to move lower if the market carried it down. That had not been achieved until today, and--as he had suggested earlier--today's decline might prove temporary. The Desk's more general objective over the past several weeks had been to maintain a funds rate in the neighborhood of 12 per cent. He would interpret adoption of the alternative B specifications as reflecting a desire by the Committee to have the funds rate brought down to about 12 per cent, assuming that could be done without flooding the market with reserves.

Mr. Morris remarked that, in light of that interpretation, he would support the modified version of the alternative B specifications for the aggregates proposed by the Chairman. With respect to the Federal funds rate, however, he would be happy with the original alternative B range of 11 to 13 per cent; he did not understand the Chairman's purpose in suggesting that the lower limit be raised to 11-1/2 per cent.

Chairman Burns said his purpose could be simply stated. If the funds rate, which recently had been around 13-1/2 per cent,

were to decline to a level as low as 11 per cent, the drop would be likely to be interpreted by the market as an easing of Federal Reserve policy. Such an interpretation would be unfortunate at this time.

Mr. Morris asked whether a decline in the funds rate to, say, 12 per cent would not produce a similar reaction.

The Chairman replied that that was a possibility. He might note, however, that open market operations throughout the recent period in which the funds rate had been well above 13 per cent had probably made it clear to the market that the Desk was trying to bring the rate down. He asked whether the Manager agreed with that view.

Mr. Holmes said he did. He went on to comment that in his view a decline in the funds rate to levels significantly below 12 per cent was likely to be over-interpreted by the market. Some participants were now predicting that the Federal Reserve would ease up a bit to help the Treasury in the forthcoming refunding and then tighten up again after the refunding was over.

Chairman Burns remarked that he also had another consideration in mind. In private conversations with both Administration officials and Congressmen, he had been urging that some steps be taken in the direction of fiscal restraint. While he could not

describe the prospects of success as clearly good, the possibility of some success was more than a faint one. In his judgment, however, that possibility would be reduced if at this juncture the System were to take actions that were publicly interpreted as easing.

Mr. Coldwell said he thought it was necessary for the Committee to recognize the uncertainties in financial market conditions at present. He would be somewhat concerned about adopting any of the staff's alternatives for the operational paragraph of the directive, since all of them focused on relationships between money market conditions and monetary aggregates. He would prefer language along the following lines: "To implement this policy, the Committee favors a restrictive posture both in terms of money market conditions and the rate of growth in monetary aggregates, while taking account of the forthcoming Treasury financing and the uncertain conditions in the domestic and international financial markets."

With respect to specifications, Mr. Coldwell continued, his first choice for the aggregates would involve growth rates 1/4 to 1/2 of a percentage point below those suggested by the Chairman. There was not much point in debating so small a difference, however, and he was prepared to accept the Chairman's

figures. He favored a range for the Federal funds rate of 11-1/2 to 13-1/2 per cent.

Mr. Balles remarked that the staff's outlook for the economy could be summarized as follows: over the next 12 months the growth rate in real GNP would be 1 per cent or less; the rate of inflation would still be about 6 per cent in the second quarter of next year; and the unemployment rate would be about 6-1/2 per cent at that time. That sort of summary drove home an unpleasant truth about monetary restraint--namely, that the bad news, in the form of a dampening of business activity, came first, and the good news, in the form of a diminished rate of inflation, came later. He would urge the Committee to face up to that unpleasant truth and hold to its present course; if it failed to do so, he feared that it would simply make no progress in reducing the rate of inflation.

Mr. Balles said he would like to associate himself strongly with Mr. Morris' view about the desirability of lengthening the planning horizon for monetary policy. It was important that the Committee try to assess the eventual effects of its policy actions as well as it could, given the limitations of economic forecasting. While knowledge regarding lags was certainly limited and far less precise than one might like, it was nevertheless clear that the lag in the effect of a policy change on prices was somewhat longer--

perhaps considerably longer--than the lags with respect to the impact on production and employment.

Mr. Balles then expressed the view that it was necessary to keep a careful watch on the CD, Federal funds, and commercial paper markets. As the members no doubt were aware, some unhealthy developments were occurring in those markets as a consequence of the Franklin National and Bank Herstatt problems. For example, the senior financial officer of a large West coast industrial company had recently mentioned that he planned to recommend that the firm withdraw completely from investments in CD's and commercial paper and move exclusively into Treasury securities, in order to avoid the risk of unknown weaknesses of large banks. In the course of a lengthy discussion, he (Mr. Balles) had expressed shock and dismay at such a plan and had noted that if many firms pursued that course they would create the very conditions they would be trying to protect against. Subsequently, the financial officer had indicated that the firm's decision had been far less Draconian. Still, it involved limiting holdings of CD's to those issued by the 10 largest banks in the country and drastically paring the number of companies whose commercial paper would be bought.

Mr. Balles observed that such decisions by bank customers would put great pressures on some banks not among the largest

even though they might be in an essentially sound condition. He had had that fact in mind earlier today when he had suggested that the System stand ready to offer assistance through the discount window to banks experiencing such pressures. He would make a sharp distinction between banks that were suffering the consequences of their own imprudent behavior--in making excessive loan commitments and granting excessive lines of credit--on the one hand, and banks that had kept their loans under control but were experiencing problems mainly because of a sudden diminution in their ability to roll over CD's on the other hand. While the System might offer some discount window assistance to banks in the first group, it should also let them incur the capital losses that would be involved in sales of Treasury and municipal securities as part of a program to restore their liquidity positions. However, he would be inclined to take a more generous attitude toward banks in the second group, because their problems would be a consequence of the frightened atmosphere in financial markets and not of their own making.

With respect to today's policy decision, Mr. Balles continued, he agreed with those who thought the System now had about the right degree of restraint in place. He had intended to suggest a slight shading of the specifications shown under alternative B, and could easily concur in the Chairman's suggestions. He saw

nothing wrong with the directive language associated with alternative B.

Mr. Kimbrel said he was not unmindful of the scattered questions being raised about the solvency and liquidity of some financial institutions. He hastened to add, however, that he hoped the System would not overreact. He still found rather widespread acceptance of the need to continue efforts to contain inflation, even on the part of those experiencing extreme pressure. In view of recent monetary growth rates, he found it difficult to believe that the System's policy was unduly restrictive.

Turning to the directive, Mr. Kimbrel observed that a money market formulation might tend to raise questions regarding the Committee's determination to control growth in the aggregates. Accordingly, he would prefer to cast the directive in aggregate terms. In his view, it would be desirable under present circumstances to give the Manager somewhat more leeway than usual while seeking to maintain the present degree of restraint. He would be reluctant to have the Federal funds rate remain above 13 per cent for long. He would be even more reluctant, however, to have it fall below 12 per cent in the very near term because of the likelihood that such a drop would be erroneously interpreted as a premature move toward ease. The specifications the Chairman had suggested were quite acceptable to him.

Mr. Eastburn observed that he also found the Chairman's specifications quite acceptable. In his own thinking about monetary policy he had been trying to separate questions of strategy and tactics. As far as strategy was concerned, he believed the point made earlier about the need to lengthen the policy planning horizon was entirely correct. If there had been any deficiency in the Committee's procedures over the last year or so, it lay in an unduly narrow focus on the short run. The consequence was that the longer-run targets had been missed.

However, Mr. Eastburn continued, he thought tactical considerations were of particular importance at this time. The more closely one observed market conditions, the more fully one appreciated that fact. In recent weeks, for example, there had been a sharp and inexplicable decline in the prices of the stock of certain Philadelphia banks, in some cases amounting to 20 or 25 per cent in a very short period. Moreover, the bank suffering the largest reduction in its stock prices was probably one of the two most liquid in the city. It was clear, as Mr. Balles had suggested, that some banks were victims of circumstances beyond their control. The existence of such situations made it necessary for the Committee to consider carefully the tactics it employed in attempting to reach its strategic goals.

Mr. Eastburn expressed the view that the specifications suggested by the Chairman blended quite well the needs of longer-run targets and short-run tactics. He would like to see the Federal funds rate kept near the upper end of the indicated range; he had the impression that maintenance of the rate at about 13 per cent would have a beneficial effect on the market, and that a reduction to 12 per cent not only was unnecessary but might in fact produce mistaken assumptions about the Committee's intentions. For directive language he continued to prefer an aggregative to a money market formulation, and he liked the language of alternative B.

Mr. Black said he thought all members of the Committee agreed that inflation was the main problem, that close control over the monetary aggregates was consequently necessary, and that such a course involved serious risks. There were differences of view regarding the point at which those risks arose and regarding their magnitude. In his judgment, the risks were now acute; the possibility of imminent and dangerous financial disruption had to be contemplated.

Under such circumstances, Mr. Black continued, it might be a mistake for the Committee to try to adhere too closely to any specific numerical targets for the monetary aggregates. He would be inclined to think in terms of some outer limits beyond

which the Committee would not press in the interest of reducing the risk of financial collapse. For the present the Committee should give priority to maintaining the viability of financial markets and to insuring the kinds of flows through those markets needed to finance the capital expansion that was vital for the longer-term solution of the inflation problem.

For the coming inter-meeting period, Mr. Black observed, he would favor continuing to focus on money market conditions. The modified alternative B specifications the Chairman had suggested seemed generally appropriate. He would not be overly concerned if it proved necessary to permit the growth rates in the aggregates to run somewhat above the longer-run target rates in order to keep the funds rate below 13 per cent. He hoped, however, that the funds rate could be kept generally within the 11-1/2 to 13 per cent range without permitting unduly rapid growth in M_1 and M_2.

As to the directive, Mr. Black said he favored retaining the money market formulation adopted at the preceding meeting. If the members were inclined toward the formulation of alternative B, however, he would suggest revising the staff's draft to indicate that the Committee sought to achieve bank reserve and money market conditions "consistent with moderate growth" in

monetary aggregates, rather than that it sought to achieve conditions "that would moderate growth" in the aggregates. He hesitated to add another candidate to the list of possible directives, but he thought such language would come closer to expressing the objective he favored than did the original language of alternative B.

Mr. Clay remarked that he agreed with the statement in the blue book that the possibility of a credit crunch in financial markets could not be ignored. However, that potential problem, as well as others, was in large part a consequence of the inflationary environment and would persist until inflation was brought under control. He felt that the possibility of a credit crunch existed in any program that was designed to reduce inflation and that did not validate past inflation.

Mr. Clay said it was becoming obvious that the Committee could not get inflation under control by continuing to maintain an average growth rate of 7 per cent in M_1, as suggested under alternative A. Neither could it get low interest rates over the long run by following such a policy. Moreover, even though alternative B called for a moderation in the growth rate, the specifications implied a year-over-year increase in M_1 of 6.4 per cent, which would be in excess of the 6.1 per cent increase achieved last year. Alternative B also contemplated a substantial reduction in the funds

rate, which under current conditions would appear to require an undesirably large injection of nonborrowed reserves.

Accordingly, Mr. Clay continued, while he would accept the wording of alternative B, he would prefer specifications that fell between those of alternatives B and C. Specifically, he would recommend target growth rates for the third and fourth quarters combined of 4-3/4 per cent for M_1, 5-3/4 per cent for M_2, and 6-3/4 per cent for the bank credit proxy. Associated ranges for the July-August period would be 3-1/2 to 5-1/2 per cent for M_1, and 5 to 7 per cent for M_2. That set of specifications would result in an M_1 growth rate of 6 per cent for 1974, which was virtually the same as that for 1973. A Federal funds rate range of 12 to 13-1/2 per cent would appear consistent with those targets.

However, Mr. Clay observed, he doubted that the specifications he recommended would be acceptable to the Committee. He thought the specifications proposed by the Chairman were a step in the right direction--indeed, he preferred them to any of the alternatives shown in the blue book--and he would be prepared to accept them for the period immediately ahead.

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

Mr. Partee remarked that the specifications the Chairman had proposed struck him as satisfactory for the time being. He would not be stating his views in full if he failed to add that, in his judgment, the time at which it would be necessary to move toward ease was rapidly approaching. However, he could see the strategic value, in terms of dampening inflationary psychology, of maintaining what appeared to be an extreme posture of restraint in the money market for a while. He would recommend the alternative B language for the directive. It was important that the Committee pay close attention to the behavior of the aggregates at this point because there now was a good possibility that they would slacken sharply. If that happened, he thought the Committee should be prepared to move promptly to bring down money market rates.

Mr. Holland said he favored holding to about the present general degree of monetary restraint between now and the next meeting. It would be necessary to be especially watchful for potential failures of financial firms. Moreover, the Committee should be aware of the possibility that there might now be unduly depressive pressures on the monetary aggregates, even on M_1; there was a chance that when the members looked back on the period from the beginning of June to the end of August they would decide that growth in all of the major monetary aggregates had been less than

they would have liked. While the odds on such a development were probably less than even, the fact that it was a possibility should be kept in mind as the System shaped its contingency plans and policies. In particular, the Federal Reserve should have contingency plans at hand for use in case it proved necessary to help meet liquidity needs on short notice.

With respect to the directive, Mr. Holland observed that he favored language along the lines of alternative B, which referred to both money market conditions and the aggregates. He thought the modification Mr. Black had suggested would be desirable, in light of the chance that the aggregates might now be expanding too slowly. He preferred the specifications the Chairman had suggested to those shown in the blue book under alternative B. If, as his instincts suggested, the aggregates would be growing somewhat less in the near term than projected, he would not want the Manager to respond by easing money market conditions rapidly or substantially. Accordingly, he favored reducing the lower limits of the 2-month ranges for the aggregates, as the Chairman had proposed. He hoped, however, that the Desk would work actively to bring the Federal funds rate down into the desired range, and to move it gradually lower within that range so long as the growth rates in the aggregates were well below their upper limits or were drifting down. And, if

market pressures again tended to push the funds rate up above 13 per cent, he hoped the Desk would act against those pressures more aggressively than it had during the recent period, and that the Manager would communicate promptly with the Chairman so that the Committee could review the situation.

Finally, Mr. Holland remarked, he would urge the Desk to place considerably more weight on purchases of bankers' acceptances as it used the various means available to it for supplying reserves. That would be to kill several birds with one stone: it would help relieve the problem of shortages of other types of securities ordinarily purchased in reserve-supplying operations; it would improve conditions in a particular market that was now under pressure; and it would indirectly have a helpful impact on markets for other private short-term paper. He noted that later in this meeting the Committee would be considering a recommendation to increase the limit on the volume of bankers' acceptances that the Desk could acquire.

Mr. Wallich said he saw no occasion for further tightening at this time, in light of the evolving economic situation. He agreed with the staff's assessment of the outlook for prices but he thought that their projections of real growth might be on the low side. If so, nominal GNP would rise more than projected. However,

the resulting increase in the demand for money would tend to be offset by the somewhat higher level of interest rates. Accordingly, he believed the alternative B targets as modified by the Chairman were about right.

Mr. Wallich remarked that he would favor formulating the directive in terms of the aggregates, partly because there was greater public acceptance of such targets at present than of targets formulated in terms of money market conditions. Also, he would be uneasy about specifying a narrow range for the Federal funds rate in view of the uncertainties ahead and the possibility of marked upward or downward pressures on that rate. He recognized that it was necessary to avoid a large decline in the funds rate, since such a decline would certainly be misinterpreted.

Mr. Bucher said he would like to put a question to the staff before expressing his views on policy. A number of speakers today had implied that the adoption of specifications similar to those of alternative B would amount to maintaining the present posture of policy. According to the blue book, however, any declines in market interest rates that might develop under the B specifications were likely to be modest and short-lived, because of the inflationary environment, continuing strong private credit demands, and Treasury and agency financings. If adoption of the B specifications resulted

after a brief period in rising interest rates, he wondered whether market participants were not likely to conclude during the next month that the Committee had in fact tightened policy.

In reply, Mr. Axilrod noted that the alternative B specifications were roughly consistent with the monetary assumptions underlying the staff's basic GNP projections. If those projections were realized, growth in nominal GNP would be considerably faster than growth in M_1, and the resulting demands for money and credit would tend over the longer run to raise interest rates. A temporary decline in rates was expected during the next few weeks simply because rates had recently shot above their trend path. He did not believe, however, that adoption of the alternative B specifications would be perceived by the market during coming weeks as a tightening action, because under those specifications the funds rate would drop back toward 12 per cent. If anything, market participants might conclude that policy was a shade easier than it had been in the past 2 weeks. They probably also would conclude that the money market conditions that emerged were those the Committee had originally sought.

Mr. Bucher then said it was important to keep in mind that the task of purging the economy of inflation was going to be a long and difficult one. He agreed that the war against inflation should

be the number 1 priority. However, the Committee might very well lose that war by focusing too intently in the short run on the battle of the monetary aggregates. He would be prepared to accept the risks involved in suggesting to observers for a few weeks or a month that policy was tending to ease. Such risks should not be permitted to overwhelm other, more important, considerations, particularly since any temporary impressions of that sort could readily be reversed by clear indications that the System was determined to maintain a generally restrictive policy stance over the longer run.

At the moment, Mr. Bucher continued, the war against inflation had strong support in the Congress and among the public at large. But those positive attitudes could be changed quickly by such developments as a crisis in financial markets, a slide over the brink into recession, or even a fairly early run up in the unemployment rate. While he was willing to incur some risks in that regard, a monetary policy that was expected to result in growth of less than 1 per cent in real GNP over the next year was too close to the brink. He would prefer to aim at a slightly higher rate of growth--perhaps on the order of 2 per cent, which Mr. Partee had suggested would require expansion in M_1 at a 7-1/2 per cent rate. In terms of the blue book alternatives, he would favor the

specifications of alternative A, which included a longer-run target for M_1 growth of 7 per cent.

In sum, Mr. Bucher remarked, he was prepared in the short run to give observers the impression of a slight easing of policy, in the expectation that over the longer run the System would be able to convince them that it was continuing its determined battle against inflation. He would like to see the weekly average Federal funds rate reduced below 12 per cent, and he would favor more aggressive operations toward that end, including purchases of coupon and agency issues. Also, he concurred in Mr. Holland's comments about operations in bankers' acceptances. As to directive language, he favored alternative A, which called for bank reserve and money market conditions "consistent with growth in the monetary aggregates at about the rates prevailing over recent months."

Mr. Sheehan said he agreed in general with the views expressed by Mr. Black. He thought it would be desirable to aim at a small positive growth rate in real GNP--perhaps of 2 per cent or a bit under--in order to minimize the risks of creating a recession or contributing significantly to one. If the real growth rate were kept positive the Committee would experience less pressure to ease from the Congress and the public and would be better able to continue its fight against inflation.

Mr. Sheehan noted that the recent unexpected increase in the Federal funds rate had been attributed to technical factors. Accordingly, he was disturbed by the suggestion that a return to the level originally contemplated would be construed by the market as an easing action. He would not dissent if a Committee majority favored the specifications suggested by the Chairman, but he was uneasy about the prospect of a funds rate as high as 13 per cent. Unlike Mr. Francis, he was not pleased with the way in which the market had adjusted to rates well above 13 per cent; in his view, conditions had come too close to the precipice for comfort. He had been satisfied with the degree of tension in financial markets prior to the run-up in the funds rate, and he would now like to move back from the precipice if that could be done without recreating the pattern of last autumn. At that time, as the members would recall, the Committee had attempted to ease slightly, and market conditions had outrun its intentions. On the whole, he thought a funds rate of about 12 per cent or a little less would be appropriate at this time.

Mr. Mitchell remarked that he could agree with the policy views of almost every prior speaker, including Mr. Francis, in the sense that those views fell within his own range of tolerance for policy. He also shared the apprehensions of a number of speakers

about conditions in financial markets and the deeply troubled position of some banks. At present the capital markets were not functioning properly, nor were the markets for commercial paper and, apparently, bankers' acceptances. He would like to think the System was developing an effective approach to the problem of dealing with the troubled institutions that, in effect, were causing some markets to function inadequately or not at all.

As to the directive, Mr. Mitchell continued, the language Mr. Hayes had originally proposed had a strong appeal because it recognized the existing difficulties in financial markets. On balance, however, he favored the language of alternative B on the pragmatic grounds Mr. Wallich had advanced. He was quite willing to accept the specifications the Chairman had suggested.

Mr. Winn observed that the notion of brinksmanship in policy suggested incorrectly that there was only one way to fall; dangers lay in both directions, and it would be better to say that the Committee was walking a tightrope. He would hesitate to give a signal at this stage that would be interpreted--or misinterpreted--as easing. On the other hand, no one wanted to bring down the house of cards. He would feel comfortable with the modified B specifications the Chairman had suggested, assuming that the Desk would not be expected to be highly aggressive in its efforts to reduce the Federal funds rate to 12 per cent.

Mr. Van Nice said he favored the alternative B specifications as shown in the blue book. He would prefer to focus a bit more at this time on money market conditions than on the aggregates; he was not sure about the validity of the relationship between money market rates and growth rates in the aggregates involved in the B specifications, and if money market rates were found to be moving above or below the desired range he would favor accepting some deviation in the aggregates from their target growth rates, even growth in M_1 at a rate above the 5-1/2 per cent longer-run target shown in the blue book.

Mr. Van Nice then said he had the impression that, while the public continued to support the posture of monetary policy, there had been some change in sentiment during the past few weeks. Specifically, businessmen seemed much more worried than a month ago that the situation was very close to the brink. If the spread of such attitudes required a decline in the Federal funds rate to 11 per cent or even lower, he would not be unduly concerned so long as that was a temporary phenomenon. In the long run the financial community was likely to base its impressions of monetary policy on the growth rates recorded for the aggregates rather than on fluctuations in the funds rate in either direction.

Chairman Burns observed that there appeared to be a broad consensus within the Committee with respect to specifications, so that the main question to be resolved concerned the directive. He asked for an indication of preferences between operational paragraphs which emphasized monetary aggregates on the one hand, and money market conditions on the other.

A majority of the members expressed a preference for emphasis on the monetary aggregates.

Mr. Holland noted that Mr. Black had suggested that the alternative B language be modified to call for conditions "consistent with moderate growth in monetary aggregates" instead of conditions "that would moderate growth in monetary aggregates." He thought there were advantages to that suggestion. He might note, first, that the alternative B language implied that the Committee sought slower growth in the aggregates over the second half of the year than in some base period. Such an implication would be quite appropriate if the second quarter were taken as the base. However, assuming the July projections under alternative B were realized, the average growth rates for the aggregates in the 3 months ending in July would be below the second-quarter rates and quite close to the rates the Committee apparently favored for the second half. If that period were viewed as the base, it would be more appropriate

to call simply for "moderate growth"--a construction the Committee had used on many occasions--and avoid the implication that the objective was to drive growth rates down still further.

Mr. Hayes commented that Mr. Black's proposed language suggested an easier policy stance than the directive adopted at the previous meeting, which called for maintaining "about the prevailing restrictive money market conditions." He preferred the alternative B language, which did not convey a suggestion of easing.

After further discussion, the Chairman asked for an expression of preferences between Mr. Black's proposed language and that of alternative B. A majority indicated that they favored the latter.

Chairman Burns then suggested that the Committee vote on a directive consisting of the general paragraphs as drafted by the staff and alternative B for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, the annual rates of growth for the third and fourth quarters combined--would be 5-1/4, 6-1/2, and 7-1/2 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the July-August period would be 8-3/4 to 11-3/4 per cent for RPD's, 2 to 6 per cent for M_1, and 4-1/2 to

7-1/2 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 11-1/2 to 13 per cent.

Mr. Bucher indicated that he planned to dissent from the proposed directive.

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

The information reviewed at this meeting suggests that real output of goods and services changed little in the second quarter and that no significant expansive forces appear to be emerging. The over-all rate of price rise, while very large, was not quite so rapid in the second as in the first quarter, but the advance in wage rates accelerated. In June industrial production was unchanged, following 2 months of moderate advance, while nonfarm payroll employment edged down. The unemployment rate remained at 5.2 per cent. Wholesale prices of farm and food products declined substantially further, but increases among industrial commodities continued widespread and extraordinarily large.

Since mid-May the dollar has appreciated somewhat against leading foreign currencies. In June there was a large increase in foreign official assets in the United States, mainly reflecting investments by oil-exporting countries. The foreign trade deficit increased sharply in May, as exports declined and imports rose further.

Growth in the narrowly defined money stock was somewhat more rapid in June than in May; growth during the second quarter was close to the 7 per cent first-quarter pace. Net inflows of consumer-type time deposits at banks

and at nonbank thrift institutions increased in June, but deposit experience at the nonbank institutions deteriorated late in the month. Growth in business loans and in total bank credit slowed in June, and banks added much less to their outstanding volume of large-denomination CD's than in April and May. Private market interest rates have risen substantially in recent weeks, and in association with uneasy conditions in financial markets, yield spreads between prime and lower quality issues have widened. Yields on long-term Government securities have increased relatively little, and those on Treasury bills have declined somewhat.

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

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

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

Chairman Burns noted that a memorandum from the Account Manager, dated July 9, 1974, and entitled "Outright System Activity in the Agency Market," had been distributed to the Committee.[1/] He asked Mr. Holmes to comment.

Mr. Holmes said he believed his memorandum, and the attached memorandum from Mr. Ozog reviewing outright System operations in

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

agency issues since their inception in September 1971, were self-explanatory. The recommendations contained in his memorandum were that the guidelines governing agency operations be amended by dropping guidelines 4 and 7. Elimination of those guidelines would permit the roll-over of maturing agency issues and the purchase of new agency issues on the issue date rather than after a 2-week "seasoning" period. The first recommendation, if adopted, would avoid the negative reserve impact that occurred when agency securities matured. While that reserve impact had been manageable, it had become larger as the System's portfolio of agencies had increased. The second recommendation would increase the availability of agency securities for System purchase, since the bulk of transactions in the agency market consisted of trading in new issues.

Mr. Holmes remarked that the adoption of both recommendations should help in over-all reserve management in the present unusual circumstances, in which Treasury bills had become scarce commodities and dealer positions had become virtually non-existent.

After discussion, the Committee agreed that the Manager's recommendations should be approved.

> By unanimous vote, the guidelines for the conduct of System operations in Federal agency issues were amended, effective immediately, to delete guidelines numbered 4 and 7, and to renumber the remaining guidelines as 4, 5, and 6.

The Chairman then noted that a memorandum from the Manager, dated July 10, 1974, and entitled "Limit on Outright Holdings of Bankers' Acceptances," had been distributed to the Committee.[1] He asked Mr. Holmes to comment.

Mr. Holmes observed that a memorandum from Mr. Cooper dated July 10, 1974, a copy of which was attached to his own memorandum to the Committee, included a recommendation that the Federal Reserve Bank of New York drop its policy of requiring dealers to add their endorsement to any acceptances purchased by the Desk for either System or foreign accounts if the Committee approved a second recommendation: to increase the limit on outright holdings of bankers' acceptances, contained in paragraph 1(b) of the Authorization for Domestic Open Market Operations, from $125 million to $500 million. Given the volatile state of the markets, and the fact that the two recommendations were quite separable, the Federal Reserve Bank of New York had dropped that endorsement requirement last Friday. The action was welcomed by the dealers, who were concerned both about investor reluctance to buy paper except that of the largest banks and about the size of their contingent liability--close to $1 billion--on endorsements made on behalf of the Federal Reserve.

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

As Mr. Cooper's memorandum indicated, Mr. Holmes continued, the endorsement policy was an archaic one adopted in the earliest days of the System and viewed originally--at least in part--as a means of encouraging the market by adding to dealer income. Dropping the requirement would result in a small dollar saving to the System that would more than offset any additional cost that an expansion of activity might entail.

Mr. Holmes remarked that enlarging the portfolio limit to $500 million would be a modest help in the System's reserve-supplying activity in the present period of shortages of Government securities, and it should give some encouragement to the market. It would also put the Desk in a position to handle any foreign sale of acceptances should the market not be able to do so. He might note that since last Thursday the Desk had expanded its operations in acceptances, and its holdings of acceptances were now at the present $125 million limit.

Mr. Holmes added that some publicity had been given to the constraint of the $125 million limit on System purchases of acceptances. Accordingly, if the Committee approved the increase, he thought the action should be made public promptly.

Mr. Morris asked whether a larger increase than the Manager had recommended might not be desirable, in view of the shortage of

other securities of the types the Desk normally purchased in supplying reserves.

In reply, Mr. Holmes expressed the view that a limit of $500 million would not constrain the Desk from making necessary purchases of bankers' acceptances for some time. Should such a limit appear likely to become a constraint, he would plan on recommending a further increase to the Committee. He would not recommend setting a higher figure now because of the possibility that market participants would assume that the System planned to make purchases on a larger scale than actually contemplated.

After further discussion, it was agreed that Mr. Holmes' recommendation should be approved.

> By unanimous vote, paragraph 1(b) of the Authorization for Domestic Open Market Operations was amended, effective immediately, to read as follows:

> To buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers' acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers' acceptances held at any one time shall not exceed $500 million.

Mr. Broida noted that on June 27, 1974, he had distributed a memorandum to Committee members and Reserve Bank Presidents not currently serving, asking whether they would prefer to shift the October 15 meeting date listed on the tentative schedule for 1974 either to October 16 or October 22, in view of the fact that the day preceding October 15 was Columbus Day, a national holiday.[1/] While a number of the respondents indicated that they would prefer not to meet on the day following a holiday, two advised that they would have major conflicts if the meeting were shifted to October 16, and two reported that such conflicts would be produced by a shift to October 22. Accordingly, he suggested that the Committee retain the October 15 date shown on the tentative schedule.

There was general agreement with that suggestion.

It was agreed that the next meeting of the Committee would be held on August 20, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

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

ATTACHMENT A

CHAIRMAN OF THE BOARD OF GOVERNORS
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

July 16, 1974

The Honorable William E. Simon
Secretary of the Treasury
Department of the Treasury
Washington, D. C.

Dear Bill:

In view of the possibility that you may be engaging in talks about the provision of financial assistance to Italy, I am writing on behalf of the Federal Open Market Committee to clarify the status of the $3 billion reciprocal currency arrangement (swap line) between the Federal Reserve System and the Bank of Italy.

The swap facility can be drawn on subject to the conditions and limitations arising from its nature and purpose. It has always been understood by both central bank parties to the swap arrangement that swap drawings are available only to meet short-term needs. Drawings are normally made for a period of three months, and while they may sometimes be renewed, it is in no case envisaged that they will remain outstanding for longer than one year. Therefore the swap line cannot be used to make any contribution to medium-term or long-term financing needs.

In present circumstances, recognizing that

(a) the Italian authorities now appear to be taking substantial actions toward bringing about needed adjustments in the domestic Italian economy and in the Italian balance of payments, and that

(b) some time may be needed to arrange an appropriate package of external financial assistance for Italy,

the Federal Reserve System would be prepared to allow the Bank of Italy to make some use of its swap line for interim, short-term financing purposes.

We have had no specific discussions with the Bank of Italy about this. But, for your information, the Federal Open Market Committee which decides these matters has been thinking along the following lines. It would be appropriate for the Bank of Italy -- in anticipation of obtaining longer-term financing -- to draw, say, $250 million initially, and to draw up to an additional $250 million subject to conditions to be specified, such as that Italy obtain commensurate amounts on comparable terms from other sources, including other central banks and particularly the U.S. Exchange Stabilization Fund. It would be expected that these drawings would be repaid within three months, subject to periodic extensions, if necessary, up to one year.

For any drawings by the Bank of Italy on the System beyond $500 million, the Committee would expect, in addition to commensurate Italian drawings on other sources, that firm take-out provisions would be negotiated (e.g., by the pledge of proceeds from prospective IMF drawings or of gold collateral), so that the repayment of such swap drawings within one year would be assured.

I am sure you will agree that it would be helpful if you were to note, should the subject of the System's swap arrangements arise in your talks, that decisions concerning these arrangements are in the province of the Federal Open Market Committee.

Sincerely yours,

Arthur F. Burns

ATTACHMENT B

Henry C. Wallich
July 16, 1974

Report on the BIS Governors' Meeting - July 8, 1974

In place of the usual survey of country problems, the following issues received fairly intensive discussion:

(1) Guidelines or rules for liquidity, solvency, and for exchange exposure of banks.

(2) Lender-of-last-resort responsibilities.

(3) Redepositing of reserves by central banks in the Eurodollar market.

(4) The Herstatt failure.

(5) (at the dinner meeting) Possible use of OPEC funds by the BIS.

(1) Guidelines

Gordon Richardson described the approach of the Bank of England as focusing principally upon the quality of management. Within this context, the Bank of England, he said, judges the adequacy of a bank's free reserves and its liquidity ratio. The Bank obtained detailed data on the maturity structure of Eurocurrency operations each quarter, which so far had shown no unsatisfactory trend. Failure to maintain adequate liquidity in terms of asset-liability structure leads to a discussion of the Bank of England with the individual bank. As regards foreign exchange positions, the Bank of England sets individual limits on the open position against sterling for each bank, as well as on the position of spot

against forward. No limits are placed on positions in currencies other than sterling, but this might have to be explored in future.

Clappier (France) indicated that France had tight control over its banks but that foreign currency transactions still remained in part uncontrolled. The Bank of France is working with the commercial banks on an information procedure covering the foreign currency position as well as the relation between the maturity structure of assets and of liabilities. Commercial banks are interested in and receive the resulting composite information on a voluntary basis.

Vandeputte (Belgium) said that Belgian controls over the capital ratios of banks had become more lenient in recent years. The spot and forward position in each currency for each bank was watched by the authorities. Controls are maintained only on the over-all open position in Belgian francs but not for each currency.

Zijlstra, Richardson, Clappier, and Vandeputte expressed an interest in developing more information on exchange positions and in possibly coordinating this information internationally.

(2) Lender-of-Last-Resort Function

Richardson laid out in detail what he considered proper policy with respect to particular banks.

(a) For British banks the Bank of England would assume full responsibility if it considered support to be justified.

(b) For consortium banks, he saw no way of assigning responsibility but hoped that the prestigious banks participating in the consortium banks would stand back of their subsidiary.

(c) For wholly or majority owned foreign subsidiaries, the Bank of England would feel a certain responsibility to enlist support to insure a healthy banking system within its own country. This responsibility would be met, however, by seeking to enlist the help of the central bank of the majority shareholder.

(d) In cases where the difficulties experienced were in dollars, Richardson hoped that assistance would be forthcoming from the Federal Reserve if the amounts in dollars required proved an embarrassment to the Bank of England.

Klasen (Germany) agreed with Richardson's assignment of responsibility to central banks as lender of last resort in cases where assistance was justified. He entered general reservations, however, regarding the appropriateness of assistance.

I pointed out that it was difficult to generalize about lender-of-last-resort responsibilities, referring to the difference between liquidity and solvency problems, between branches and subsidiaries, to problems of availability of collateral, of the degree of supervision that a foreign central bank could exercise over branches and subsidiaries of its banks abroad, and of the supervision and regulation applied by the host country authorities. I added

that a central bank had to be strongly conscious of its responsibilities as lender of last resort but that these had to be viewed also in the context of whether the problem was a macro or a micro problem, whether the need was to provide liquidity for a whole market or to bail out a particular institution, and how a rescue operation could be reconciled with the over-all needs of monetary policy.

(3) Redepositing in the Eurodollar Market

Several representatives, especially those of England, Italy, and Holland, suggested that the "self-denying ordinance" not to place central bank reserves back into the Eurodollar market might have to be lifted. Their objective apparently was to increase the lending power of the Eurodollar market, reflecting a concern that a growing proportion of the OPEC money will flow to New York. Klasen spoke against the proposal. His concern was with the inflationary consequences of this redepositing, which in effect creates additional Eurodollars. I supported him on the same grounds and also by pointing out that it is not attractive for the U.S. to find that other countries in effect are creating dollars which could give rise to lender-of-last-resort responsibilities. No clear decision was reached on this matter.

(4) Herstatt Failure

Klasen described the circumstances leading to the decision to close the Herstatt bank. He regretted the losses suffered by American banks, which, he said, were shared by German banks, but

absolved the German authorities from responsibility. Wallich and Coombs argued that the world payment mechanism was affected by the failure and that the liquidity of some American banks was affected by the delays that had had to be imposed on the clearing mechanism in order to guard against further losses. Failure to undo the damage to American banks, Coombs said, would lead the market to regard spot purchases and sales of exchange as credit transactions and would slow the mechanism as well as hurt small banks trying to deal in spot exchange. No strong complaints were voiced by European central bankers, contrary to expectations, about the slowing of the clearing mechanism in New York.

(5) BIS Recycling of OPEC Funds

At the dinner meeting, Zijlstra spoke of the possibility that the BIS might soon receive very substantial OPEC funds, and examined the terms on which the BIS could accept and relend these. The principles he set forth, which were not universally endorsed, involved (a) no active solicitation of funds on the part of BIS, (b) the need for the BIS to obtain guidance on the political decision involved in choosing among potential borrowers, and (c) the need of the BIS for guarantees by the EEC or a wider group against losses. Zijlstra's discussion of the prospects of such a deal was not sufficiently precise to permit this possibility to be built into any particular assistance package that might have to be discussed outside the BIS in the near future.

ATTACHMENT C

Helen B. Junz
July 30, 1974

Summary notes on OECD's Economic Policy
Committee Meeting - June 24-25, 1974

In their meeting in June 1974, members of the Economic Policy Committee (EPC) took up once again the dialogue that had started in November of last year: while there was unanimous agreement that the main policy concern was the need to bring the rapid increase in the level of prices under control, there was disagreement about how this should be accomplished. At the February 1974 meeting concern had shifted toward the danger of a cumulative recession in the wake of the oil crisis. However, at the time of the OECD Ministerial meeting in May 1974 countries had already swung back toward giving priority to the need to control inflation. And this view was put forward even more forcefully during the meeting of the EPC.

Countries were, however, divided in their view whether sufficient restraint had already been put in train in order to achieve the goal of moderation in inflation rates or whether continued, and perhaps even further, restraint was needed. Those countries who felt that continued restraint was needed (U.S., Germany, Italy, Japan, France, Australia, Austria, Belgium, Netherlands, Switzerland, Ireland, and Greece) argued essentially that inflationary trends had been accelerating long before the oil crisis and that a relatively prolonged cooling off period, during which economic growth would be rather less than

the long-term trend would indicate, was necessary in order to eliminate inflationary expectations. A majority of these countries favored traditional demand management tools to accomplish their objective. In the event that generalized restraint might cumulate to a more severe downturn than was expected, most of these countries were prepared to take the downside risk, arguing that it would be easier to deal with excess deflation than with rampant inflation.

Those countries who felt that sufficient restraint had already been built into the System (U.K., Canada, the Scandinavian countries, Spain, Portugal, and New Zealand) argued that the downside risks were too high, particularly because there was no assurance that lower inflation rates would actually be achieved in this manner. They believed that very low rates of output would be accompanied by a fall-off in productivity, leading in turn to higher unit labor costs and a situation of stag- or even slump-flation. Under these conditions, there was the added risk that trade positions would move into even greater imbalance than existed currently. Thus, prolonged generalized restraint would lead to a cumulative downturn, which might be followed by overly reflationary measures and renewed inflationary pressures, i.e., a classical stop-go cycle. The countries in this group thus preferred demand management policies designed to run their economies at pressures of demand that would minimize the downside risks. In addition, they favored the use of selective measures, such as subsidies,

tax relief of various sorts, and other measures aimed at moderating wage demands.

With respect to the achievement of better external balance, prescriptions also differed. Countries in generally weak positions felt that surplus countries should relax demand restraints as early as possible and maintain a level of growth approaching full capacity (U.K., France, Italy, the Scandinavian countries, Ireland, and New Zealand), while the stronger countries felt that their main contribution lay in helping to moderate world inflation (U.S., Germany, Japan, and Austria).

ATTACHMENT D

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on July 16, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services changed little in the second quarter and that no significant expansive forces appear to be emerging. The over-all rate of price rise, while very large, was not quite so rapid in the second as in the first quarter, but the advance in wage rates accelerated. In June industrial production was unchanged, following 2 months of moderate advance, while nonfarm payroll employment edged down. The unemployment rate remained at 5.2 per cent. Wholesale prices of farm and food products declined substantially further, but increases among industrial commodities continued widespread and extraordinarily large.

Since mid-May the dollar has appreciated somewhat against leading foreign currencies. In June there was a large increase in foreign official assets in the United States, mainly reflecting investments by oil-exporting countries. The foreign trade deficit increased sharply in May, as exports declined and imports rose further.

Growth in the narrowly defined money stock was somewhat more rapid in June than in May; growth during the second quarter was close to the 7 per cent first-quarter pace. Net inflows of consumer-type time deposits at banks and at nonbank thrift institutions increased in June, but deposit experience at the nonbank institutions deteriorated late in the month. Growth in business loans and in total bank credit slowed in June, and banks added much less to their outstanding volume of large-denomination CD's than in April and May. Private market interest rates have risen substantially in recent weeks, and in association with uneasy conditions in financial markets, yield spreads between prime and lower quality issues have widened. Yields on long-term Government securities have increased relatively little, and those on Treasury bills have declined somewhat.

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

OPERATIONAL PARAGRAPH

Alternative A

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

Alternative B

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

Alternative C

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

ATTACHMENT E

July 16, 1974

Points for FOMC guidance to Manager in Implementation of directive		Specifications (As agreed, 7/16/74)
A. Longer-run targets (SAAR): (third and fourth quarters combined)	M_1	5-1/4%
	M_2	6-1/2%
	Proxy	7-1/2%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (July-August average):		8-3/4 to 11-3/4%
2. Ranges of tolerance for monetary aggregates (July-August average):	M_1	2 to 6%
	M_2	4-1/2 to 7-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		11-1/2 to 13%
4. Federal funds rate to be moved in an orderly way within range of toleration.		

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

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.