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 15, 1975, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Baughman
Mr. Bucher
Mr. Coldwell
Mr. Eastburn
Mr. Holland
Mr. Jackson
Mr. MacLaury
Mr. Mayo
Mr. Wallich
Mr. Debs, Alternate for Mr. Hayes

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

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

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Mr. Gramley, Economist (Domestic Business)
Mr. Solomon, Economist (International Finance)
Messrs. Boehne, Bryant, Davis, Green, Reynolds, and Scheld, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Miss Klaput, Open Market Secretariat, Board of Governors

Mr. Leonard, First Vice President of the Federal Reserve Bank of St. Louis

Messrs. Eisenmenger, Parthemos, Jordan, and Doll, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, St. Louis, and Kansas City, respectively
Messrs. Hocter and Brandt, Vice Presidents, Federal Reserve Banks of Cleveland and Atlanta, respectively
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Mr. Ozog, Manager, Securities and Acceptances Department, Federal Reserve Bank of New York

Chairman Burns welcomed Mr. Philip C. Jackson, recently appointed to the Board of Governors, to his first meeting of the Federal Open Market Committee.[1/] The Chairman noted that the President had attended the swearing-in ceremony in the Board's building on the preceding afternoon and in the course of brief remarks had strongly endorsed the independence of the Federal Reserve System.

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

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on June 16-17, 1975, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on May 20, 1975, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period June 17 through July 9, 1975, and a supplemental report covering the period July 10 through 14, 1975. Copies of these reports have been placed in the files of the Committee.

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

> The dollar has strengthened sharply since the last meeting, rising by some 4 to 6 per cent against major continental European currencies, and in the process we have managed to cut our swap debt down from $582 million to $200 million.
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> As has seemed reasonably clear for some time, the fundamentals have been much stronger than reflected in market rates, and the late-June announcement of a U.S. trade surplus of $1 billion for May, the fourth surplus in a row, was another strong reminder of the improved U.S. competitive position. In addition, the growing signs of an economic recovery in the United States have helped clear away the generally gloomy attitude toward the dollar in the exchanges. Although the economic recovery portends a pickup in our imports and some narrowing in our trade surplus as others remain in recession longer, it has also cleared away the markets'

exaggerated expectations that there might be further sharp declines in U.S. interest rates. In fact, the upturn in U.S. short-term interest rates in late June, which was quickly transmitted to the Euro-dollar market, had a strong effect on traders' expectations. This led to some quick reversals of short-dollar positions, which in turn triggered a rally of the dollar in the exchanges. More recently that advance has gained a momentum of its own, on further covering of speculative positions and on a favorable shift in commercial leads and lags.

This has presented us with an excellent opportunity to repay swap debt. Since the last meeting we have repaid the remaining $117 million of drawings in Dutch guilders, French francs, and Belgian francs. In marks we have continued our program of daily purchases in the market. We are purchasing $10 million every day in the market through the BIS, if conditions are right, and doing what we can in New York later in the day. The amounts are quite modest usually, but on days when the dollar has been particularly buoyant, we have acquired additional amounts. Also, last Friday, the Bank of England--which had previously acquired mark balances for its own possible intervention in that currency--offered us $53 million worth of marks, which we took. So over the period, we have repaid $265 million on our mark drawings, leaving only $200 million outstanding. I hope we will be able to clear the rest off our books by the next FOMC meeting.

The recovery of the dollar is, of course, still in a relatively early stage, and setbacks are always possible. In the currently favorable market atmosphere, however, it is not too early to begin giving careful consideration to the implications of a further sharp rise in dollar rates. Once our current swap debt is repaid--other than our two old outstanding debts to Belgium and Switzerland--we will have the potential of building up a foreign exchange reserve. The policy implications of such a course of action will require careful study by the Committee, as well as close coordination with the Treasury and with our foreign central bank partners. It would seem premature to me to undertake a major effort in this area in the immediate future, except perhaps for the acquisition of very modest working balances in marks and possibly a few other currencies, in an aggregate amount perhaps of no more than $50 million. With some further appreciation of the dollar a good possibility, now would not seem a particularly prudent time to take in a large foreign exchange position. Moreover, it would probably be preferable to give the Europeans--particularly the Germans and perhaps the Dutch--an opportunity to sell some of the dollars in their reserves that they may consider to be excess.

It is not clear how much of a real problem the so-called dollar overhang actually is. As we found in late 1973 and early 1974, the overhang can evaporate very quickly once the dollar strengthens, and some of the European central banks may be somewhat reluctant to undertake sizable dollar sales, particularly as their oil import bill is rising concomitantly with the dollar's advance. Moreover, the Germans and the Swiss, in particular, are hoping that a higher dollar rate will open the way for increased exports to the United States and to third markets where U.S. competition has been extremely strong. Some further appreciation of the dollar would not seem likely to hurt our competitive position, but in a world of floating rates and strong speculative tendencies, we will have to be alert to developments on the upside of the dollar as well as we were on the downside.

A strong dollar leaves other currencies vulnerable. The British, in particular, are concerned. Although our friends at the Bank of England remain extremely cautious, they are encouraged by the recent measures to restrain wages, and sterling has leveled off for the time being. The atmosphere remains explosive, however, and there always is a possibility of a request for a drawing under the swap line. So far the British have tended to let sterling seek its own level in the market rather than take a stand at any particular point that might prove costly in terms of reserves. This appears to me to be an appropriate approach, given the many distortions within the British economy. Should the British stabilization program appear to be succeeding, however, there may come a time when the British might decide to take a firm stand in the exchange market, and a drawing on the swap line might then be appropriate.

Finally, the French formally reentered the EC snake on July 10. Experience has shown that as long as the snake includes only strong currencies, it works reasonably well, but the inclusion of a currency considered fundamentally weak by the market can have, and has in the past had, disruptive effects. The market believes that there were many temporary factors behind the French franc's rise last spring, and speculation against the franc has already exerted a drag on the other snake currencies against the dollar. I have nothing to recommend at this time, but I think both the British and the French situations bear close watching by this Committee.

Mr. Coldwell asked about the status of the long-outstanding drawings on the swap line with the National Bank of Belgium.

Mr. Holmes replied that no progress had been made since the last meeting. Negotiations with the Treasury concerning the sharing of losses with the National Bank of Belgium would continue, and if agreement was not reached by the time of the next meeting, he would be prepared to recommend to the Committee a program to repay the drawings.

Mr. Holland said he wished to compliment the Manager for his foresighted and provocative suggestion that the Committee consider the policy implications of continued appreciation of the exchange value of the dollar. He hoped that the Committee would give thought to contingency planning appropriate to such circumstances.

Chairman Burns remarked that the Manager's suggestion to acquire a modest reserve of foreign currencies appeared to be good contingency planning. If the dollar was expected to appreciate further, however, the System would not want to build up a large inventory of foreign currencies in the near future

Mr. Wallich commented that as long as the System continued to hold a large short position in Belgian francs, accumulation of a separate small long position would improve its overall position.

Mr. Holland observed that the System's short position was even larger in Swiss francs than in Belgian francs. In any case, he agreed that, initially at least, only modest inventories should be accumulated. However, a case could be made for building a more substantial inventory, and he would suggest that the matter be studied. In the future, such a reserve of foreign currencies might provide the principal means for repaying swap drawings. Appropriate loss reserves could be set aside, and any actual losses on transactions could be viewed in much the same way as were the losses that were sustained at times on System transactions in domestic securities.

Mr. Pardee commented that some countries would object to System acquisitions of reserves of their currencies.

Mr. Holland said he would not advocate building up currency reserves in cases where the country concerned objected. In general, however, he viewed acquisition of foreign currency reserves as a step in the direction of greater international cooperation.

Chairman Burns remarked that the whole subject of foreign currency reserves required careful study.

Mr. Bucher suggested that the recently appointed Subcommittee on the Foreign Currency Instruments, of which Mr. Wallich was Chairman, be asked to include the subject among those it was investigating.

Chairman Burns concurred in Mr. Bucher's suggestion.

Mr. Wallich remarked that in its first meeting, held earlier today, the Subcommittee had decided that the accumulation of a foreign exchange reserve was one of the subjects it should study.

Mr. Holmes asked whether his understanding was correct that there were no objections to the near-term accumulation of modest working balances in a few foreign currencies, amounting to the equivalent of no more than $50 million.

Chairman Burns said he would support such a course, and no members expressed objections.

Mr. Wallich observed that the Manager's written reports seemed to treat System purchases of foreign currencies in the New York market, but not purchases through the BIS, as "intervention." He asked whether such a distinction was intended.

Mr. Holmes replied that several techniques were being used to acquire foreign currencies for the same purpose--that of repaying drawings on the swap lines.

Mr. Pardee added that when the Desk was acquiring currencies to repay debt, it tried to avoid having any noticeable influence on the market. Operations conducted with a view to influencing market psychology in the hope of affecting exchange rates might more properly be described as "intervention."

In response to a question by Mr. Holland, Mr. Pardee said that market participants did not know about the purchases through the BIS, and some were wondering where the System was obtaining its German marks.

Chairman Burns asked why it was advantageous to conceal the fact that the System was purchasing German marks through the BIS.

Mr. Pardee replied that the market was generally aware that the System had a substantial debt denominated in German marks and would react upon learning that the System was acquiring marks through market purchases. In the process of repaying debt, it was preferable to avoid exerting such an influence on the market. For that reason, he looked forward to the time when the debts were reduced to the point where they would no longer be a potential influence on the market.

> By unanimous vote, the System open market transactions in foreign currencies during the period June 17 through July 14, 1975, were approved, ratified, and confirmed.

Mr. Holmes reported that eight drawings on the German Federal Bank, totaling about $148 million, would mature in the period from August 1 through August 22, 1975; four of the drawings were second renewals and four were first renewals. He believed that substantial progress would be made in reducing the drawings, but he would recommend renewal of all of them, if necessary.

> Renewal for further periods of 3 months of System drawings on the German Federal Bank, maturing in the period from August 1 through 22, 1975, was noted without objection.

Mr. Holmes then reported that six swap drawings on the National Bank of Belgium, totaling $230 million, would mature for the sixteenth time in the period from August 5 through August 14, 1975. In addition, one drawing on the Swiss National Bank, amounting to $371 million, and one Swiss franc drawing on the Bank for International Settlements, amounting to $600 million, would mature for the sixteenth time on August 14, 1975. He saw no hope of repaying those drawings before maturity and recommended their renewal.

Mr. Wallich observed that the Treasury had interposed objections to System purchases of Belgian francs for the purpose of repaying the swap debt. He asked whether, if the System should be successful in its efforts to have those objections withdrawn, it would be possible to accumulate francs.

Mr. Holmes replied that it would be. Accumulation of the required amount of francs would take time and he would like to begin the operation, but he would not wish to acquire much of the currency without linking such acquisitions to repayment of the swap debt. Further negotiations with the Treasury would be held within a week or so.

Mr. Wallich remarked that the System was bound to take a loss on the purchase of Belgian francs and repayment of the swap debt. Since the System was most unlikely to be able to time its purchases to obtain the most favorable exchange rate, it ought to spread the purchases out over the period in which the market was improving in an effort to hold down the losses. Accordingly, he would favor starting to purchase francs now on the assumption that they could be used to repay the debt.

Mr. Pardee commented that the Desk planned to proceed in that way. However, he believed that the System should be very careful to link purchases with repayment of the debt. He did not believe the Belgians would be agreeable to System purchases of significant amounts without an expectation that the francs would be used for the purpose of repayment.

Mr. Holland said he believed there were both short- and long-run practical advantages in beginning the process of accumulating Belgian francs. He then noted that over time he had raised many questions about the long-outstanding swap debts. However, having in mind Mr. Holmes' answers to the questions that had been put to him today, he favored authorization of the renewals once again.

> 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 from August 5 through 14, 1975, was authorized.

Secretary's note: Notes by Governor Wallich on the July Basle meeting, which were distributed subsequent to this meeting, are appended to this memorandum as Attachment A.

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. Partee made the following statement:

> Almost all of the new quantitative and qualitative information received over the past month has continued to point in the direction of economic recovery. In general, final sales have strengthened appreciably and inventories have been drawn down on a substantial scale. These tendencies, evident now for some months, are offsetting in their immediate impact on employment and output. But both represent sources of strength for future levels of activity, since higher sales and lower inventories ultimately must lead to upward adjustments in output and to increased man-hours of work. This process has already begun in a good many industries, and in June the industrial production index is estimated to have risen four-tenths of a point. The increase was fairly broadly based, excluding only the

business equipment, metals, and construction materials industries, and it follows a period of 8 months of decline totaling almost 13 per cent.

Especially notable recently have been the stronger showing of retail sales, including automobiles, and the new information on the size of the inventory liquidation that is in process. Retail sales data were revised upward for both April and May, after publication of the green book,[1] and the advance June estimate is for a small further rise rather than the leveling off indicated by the weekly data. As a result, second-quarter sales are now estimated to have increased slightly more than 3 per cent from the first quarter--one full percentage point more than estimated in the green book. As for inventories, May data now indicate liquidation at all levels of business, amounting to a $35 billion annual rate in book value terms. This is far more than the April rate of runoff, and if it continued at anything like this pace in June, it would mean a considerably larger liquidation in the GNP accounts than the $19 billion rate of decline we had estimated for the second quarter. That, of course, would improve the prospects for a larger rebound of output in the months ahead.

The residential real estate market also has finally begun to show evidence of upturn. No June data are available as yet, but in May housing starts increased significantly, and permits increased for the second month in a row. Merchant-builder sales in May held at the much-improved April level, moreover, and the stock of new houses for sale dropped to less than an 8 months' supply at current sales rates, down from close to a year's supply in late 1974 and early 1975. Sales of existing homes have been moving upward over the last several months also, and mortgage money is reported to be in good supply in all 12 Home Loan Bank districts. Passage of the Emergency Housing Act of 1975 assures continuation of a substantial volume of GNMA-assisted mortgage financing at below-market rates for some time to come, and it has led us to increase slightly our forecast of housing starts in 1976.

All of these developments tend to strengthen our conviction that the economic upturn has now begun, and that it will be maintained--albeit at a rather moderate pace--throughout the projection period. Our green book estimates are that the increase in real GNP will average close to 6 per cent over the next four quarters--about

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

one-half point more than the projection of 4 weeks ago--and that the unemployment rate will drift down from about 9 per cent on average this summer to a little above 8 per cent by the end of next year. We still expect the rate of inflation to move downward much as before, to about 4-1/2 per cent for the fixed-weighted deflator by the end of 1976, but this does not allow for decontrol in the price of domestic oil; some program of gradual decontrol now appears to be a distinct possibility.

I believe that the latest information on sales and inventories raises the odds for a somewhat stronger economic recovery initially than the staff has projected in the green book. The room for a snapback in inventory investment, in particular, is greater than we had been estimating. But the prospects of a really vigorous recovery still appear remote, given our policy assumptions and the absence of boom conditions in housing, or in the auto market, or in plant and equipment spending. These seem unlikely to develop, for the reasons cited in last month's chart presentation. If the economic recovery does turn out to be somewhat stronger than projected, it would, of course, be all to the good. The unemployment rate would fall a little more rapidly, and the prospects for greater productivity gains would be improved. A somewhat stronger economic recovery, moreover, would seem to me to run very little risk of intensifying underlying inflationary pressures or of encouraging undue speculative sentiment, since there is ample availability of unused productive resources--both here and abroad--to support substantially higher levels of output and demand.

Mr. Bucher remarked that the data certainly seemed to bear out Mr. Partee's observation that there was an ample availability of unused productive resources. According to the staff's projections, the capacity utilization rates in the fourth quarter of 1976 would still be about 10 percentage points below the levels reached in the third quarter of 1973, both for all manufacturing and for industries producing major materials. However, he had heard comments to the effect that the statistical measures tended to overstate the actual margin of unused resources because some idle plants had been made obsolete by various developments--particularly the increase in petroleum prices. He would be interested in Mr. Partee's views on that matter.

In reply, Mr. Partee observed that the staff had not looked into that specific question. While oil was, of course, in ample supply, the rise in its price could have reduced the commercial feasibility of operating certain plant facilities. As to natural gas, limitations on the available supply could lead to shutdowns of some facilities during the winter heating season. Those possible problems would require careful attention if the margin of available capacity was small. Given the actual volume of unused capacity, however, he found it hard to believe that they would be of major dimensions.

One possible exception, Mr. Partee continued, related to industries in which production processes were heavily dependent on natural gas, such as the fertilizer industry. In view of the severity of the current recession around the world, it was highly unlikely that general bottlenecks of materials would develop within the foreseeable future, but there might well be a shortage of such materials as fertilizer. He did not have sufficient information about production processes to say what other industries, if any, fell in the same category.

Chairman Burns observed that a comprehensive inter-agency study was now under way of the possibility that bottlenecks would arise as a result of raw materials scarcities. He then noted that computation of the Board's capacity measure for major materials had always been surrounded by formidable technical difficulties. In view of the highly interesting question Mr. Bucher had raised, he wondered whether it might not be desirable to obtain the assistance of economists in the industries covered by the measure, in an effort to reappraise its reliability. Scheduling a conference of, say, 8 or 10 business economists might be a quick means of obtaining such a reappraisal.

Mr. Partee said he would look into that possibility. At this point, he might note for the information of the Committee that the measure in question was in the neighborhood of 70 per cent in the first and second quarters of this year. It had been in the low 90's in 1973, and it was projected to rise to about 82 per cent in the fourth quarter of 1976.

Mr. Morris remarked that, while he was pleased by current short-run developments, he remained concerned about the framework within which the Committee approached longer-run questions relating both to targets for monetary growth rates and projections of GNP. The latter, in a sense, also represented Committee targets. A major issue to which the Committee had not given adequate attention was the optimal rate of growth in real GNP for the first year of the recovery. The latest staff projection suggested a first-year growth rate of about 6 per cent. That would represent a sluggish recovery; the average in past recoveries had been about 8 per cent. Considering the severity of the recession, he thought a 6 per cent target for growth in real GNP over the coming year was too low.

The Chairman observed that a projected growth rate in the early stage of a recovery that was still rather fragile and uncertain was a quite different thing from actual growth rates recorded in past recoveries. In any case, the 6 per cent figure Mr. Morris had mentioned was a staff projection, not a Committee target.

Mr. Morris said he thought the projection for real GNP could be viewed as a target because it was based on a monetary policy assumption that reflected the Committee's objective for longer-run growth in M_1. The assumption, specifically, was that M_1 would rise over the projection period at a rate of 6-1/4 per cent, the midpoint of the 5 to 7-1/2 per cent range the Committee had agreed upon. In that connection, he asked whether the staff had estimated the M_1 growth rate that would be required to achieve 8 per cent growth in real GNP over the first year of expansion.

Mr. Partee replied that the staff had not made such estimates. However, some light was provided by the alternative projection, allowing for more stimulative economic policies, that had been discussed in the chart presentation at the June Committee meeting. The assumptions underlying that alternative had involved greater stimulus from both fiscal and monetary policy--which seemed more practical than relying on the latter alone--and had included an M_1 growth rate of 7-1/2 per cent over the projection period. The resulting growth rate in real GNP over the period was 7 per cent. To raise real GNP growth to 8 per cent would require still faster expansion in M_1--perhaps at a rate of 8 or 8-1/2 per cent. He had not addressed that issue in his statement today because the Committee had made a decision at the June meeting with respect to its preferences for longer-run growth rates in the monetary aggregates.

He should note, Mr. Partee continued, that the relationship between policy variables and the course of economic developments was a loose one. That was illustrated by the successive upward revisions in the staff's GNP projections in recent months, despite the absence of any notable change in the assumptions regarding policy. The key issue related to the extent to which conditions in the private sector were helping or hindering the economy as it moved into recovery. The staff still felt that on balance there was much that was hindering: housing did not appear particularly strong;

the market for automobiles was not very good; and some time apparently would be required before business fixed investment turned strongly upward. How much effort should be made to overcome such resistances to the standard kind of cyclical expansion was a question for policy makers to resolve.

Chairman Burns remarked that there also was a question of how one evaluated resistances of the kind Mr. Partee had mentioned. In the early stages of a recovery the elements of strength tended to be dim and not at all clearly visualized by economists and others, and consequently there had been a tendency historically to underestimate the vigor of expansions. One of the staff's most admirable practices--which might well be unique--was that it kept a systematic record of its successive projections for particular time periods. Preparation of that record was a salutary exercise in humility. As an example, he might cite the successive projections of the annual rate of growth in GNP, in constant 1958 dollars, for the second quarter of 1975. The first projection, made in April 1974, was for growth at a rate of $4.8 billion in the second quarter. The increase projected for the quarter was reduced in each of the next 3 months, reaching $1.7 billion in July 1974. Those figures were succeeded by projections of declines; the projection was -$2.0 billion in August 1974; it deepened irregularly to -$7.3 billion in March 1975; and it was -$1.4 billion in April and -$2.4 billion in May. In June the figure turned slightly positive, to $0.5 billion, and today--with the second quarter having just ended--it was $0.1 billion. While the staff made the best projections of which it was capable, it was clear that the figures had to be taken with a grain of salt.

Mr. Partee observed that the revisions in the estimates of change in real GNP which the Chairman had cited did not appear very large to him when considered in relation to the size of the base; in terms of constant 1958 dollars, aggregate GNP in the second quarter of 1975 was estimated at an annual rate of nearly $800 billion.

The Chairman commented that each Committee member would reach his own conclusions on how those revisions should be described.

Mr. Morris then remarked that, granting the limited accuracy of forecasts, it would be desirable from time to time for the Committee to deliberate on the question of the appropriate rate of growth in real GNP, and to ask the staff to offer its best judgment--assuming other things equal--about the kind of monetary policy that would be required to achieve that growth rate. The fact that the Committee had not followed that procedure left him with the uncomfortable feeling that it was focusing unduly on short-run developments. In sum, he was troubled by the Committee's lack of a long-term planning horizon.

Chairman Burns observed that there was considerable merit in Mr. Morris' comment. Indeed, he would be inclined to go further; since it would be misleading to assume that monetary policy was the only lever available to policy makers, he thought the Committee should also consider the implications of various possible adjustments in fiscal policy and in structural policies.

Mr. Morris indicated that he would have no quarrel with such a procedure.

Mr. Kimbrel noted that the staff projections shown in the green book still assumed only a modest further rise in the price of crude oil, reflecting an expected increase on October 1 of $1 per barrel on imports from OPEC countries. He asked whether the staff had retained that assumption for the time being simply because of the many existing uncertainties about the course of oil prices, or whether the assumption reflected the staff's best present judgment about such prices.

Mr. Partee replied that the former was the case. There were major uncertainties with respect to prices of both imported oil and the so-called "old" domestic oil. He would guess that the OPEC increase was more likely to be on the order of $2 per barrel than $1. The price of old domestic oil was particularly hard to predict because of the marked differences between the approaches proposed by the President and by Congress. He gathered from press reports that the President favored total decontrol of old oil over a 30-month period. According to staff estimates, if the President's proposal were implemented without any offsetting changes--for example, in the tax on imported oil--the GNP deflator would be about 1-1/2 percentage points higher at the end of the 30-month period than it would otherwise have been, with that increment accruing gradually over the period. As better information became available on likely price developments for both imported and domestic oil, the staff would, of course, revise the green book projections.

In reply to a question by Mr. Debs, Mr. Partee said the 1-1/2 percentage point estimate he had mentioned assumed that the price of OPEC oil would rise by only $1 this fall. The estimate did allow for a controlled deregulation of natural gas prices and for the effects of oil price increases on coal prices. However, it did not allow for "second round" effects--that is, for the prospect that workers would demand larger wage increases as a result of the faster rate of price advance and thus contribute further to the rate of price advance. Such effects would be taken into account when the projections were revised.

Mr. Wallich referred to Mr. Morris' suggestion that the Committee adopt an objective for real GNP and said he thought that each of the members had some such objective in mind. He personally was of the view that a real GNP growth rate of 6 to 8 per cent would be proper. It was probable that a growth rate in that area would be consistent with a continuing reduction in inflation, and that a higher rate would tend to revive inflation. At least in his thinking, the staff projections implied that real GNP was on target.

Mr. Wallich added that the present upturn in activity had been accurately projected. While there was a tendency for actual turning points to lag behind projections, this one had been correctly foreseen long in advance; if anything, it was occurring a bit earlier than expected. That fact, together with other considerations mentioned by the Chairman, suggested that the rate of growth projected for the next year would prove, if anything, to be on the low side. He would not take the time to note some additional factors that might work in the same direction; each Committee member no doubt had his own list of possible sources of additional strength--as well, perhaps as possible sources of weakness. In any case, he did not agree that the Committee was remiss in not adopting a specific target for real GNP; he thought it was implicitly going as far in that direction as was feasible.

Mr. Leonard said he would like to return to the question of capacity raised by Mr. Bucher. There had been a good deal of discussion in the press recently about the costs of Government regulation and its implications for economic freedom. Governmentmandated price increases affected not only the prices of goods but also the volume of output. Because Government actions could shift supply schedules and change input-output ratios in the production process, potential capacity at the present time might well be significantly below some previous level, even though the economy clearly was operating far below present capacity. In addition, some observers might be failing to distinguish between economic capacity--facilities which could be operated profitably--and engineering capacity.

Mr. Leonard remarked that monetary policy could not deal directly with cutbacks in production that originated in Government regulation rather than in policies that affected aggregate demand. It was important to be aware of the limits of aggregate demand policies as a means of expanding output without running the risk of refueling inflation. The automobile industry was a good example; the Federal Reserve had been faced with the unfortunate choice between validating the higher costs of automobiles by fostering more rapid growth in total demand, or accepting the consequences of reduced levels of output and employment in the automobile industry in the short run. In any case, he believed that there was not as much leeway as some thought for massive monetary stimulus without crossing the threshhold of renewed inflation.

Chairman Burns observed that the same conclusion could be drawn from the behavior of sensitive raw materials prices since the beginning of the year. The decline in those prices had faltered and a gentle upward trend now seemed to be under way.

Mr. Holland noted that the staff's projections were based on specific assumptions about policy, and the standard projections were supplemented from time to time by alternatives which assumed different policies. It was important that the Committee continue to consider such alternatives. For that reason, he preferred not to treat the staff's projections as targets.

As Mr. Morris had indicated, Mr. Holland continued, the rate of recovery in real GNP indicated by the current projections was below the average in past upturns. At the same time, however, the projected rise in nominal GNP was distinctly above average. The explanation, of course, was that in no previous postwar cycle had the recession and recovery been marked by so rapid a rate of price inflation. The Committee had to choose an optimal path that involved some compromise between its objectives for real activity and for prices, rather than pursue one objective to the exclusion of the other. It could not afford to stimulate real activity too much, because it also wanted to slow the rate of inflation; and it could not focus exclusively on combatting inflation, because the volume of unused resources was too great.

If the projected pattern of developments did not appear optimal, Mr. Holland observed, there were four distinct ways in which improvement could be sought. Monetary policy was one and fiscal policy another. A third, which could be called structural policies, differed from the first two in that it could simultaneously serve the objectives for both real activity and prices. For that reason, it was clear that under current circumstances structural policies should be given more emphasis and should carry a heavier load than either monetary or fiscal policy.

Finally, Mr. Holland said, there was the matter of confidence, or what might be called the "animal spirits" of the economy. Consumers and businessmen had access to a large volume of financial resources they could use to supplement income, and they would draw on those resources if their animal spirits were energized. Much of what he had read in the past month or two suggested that the economy was receiving more thrust from a revival of confidence than had been anticipated. He was quite pleased by that development because he thought a faster real growth rate could be tolerated when generated by such forces than when brought about by monetary stimulation. If the System were to press money on the economy at a rapid rate in an effort to stimulate demand, it would build up a backlog of spending power that involved potentially unhappy "carriage wheel" effects over the longer run. While he would not have been willing to adopt longer-run targets for the monetary aggregates significantly higher than the Committee had agreed upon, he was happy to see greater transactions demands for money generated in the private economy by an improvement in confidence.

Mr. Baughman asked whether the staff thought there was any evidence of greater monopolistic influence on prices now than in past recovery periods. He was rather disconcerted by the frequency with which price increases were being announced in industries making cutbacks in production. Farmers were planning to hold about as large a proportion of their current crops as they ever had in the past. From his contacts with bankers and officials of savings and loan associations, he had the impression that they were more concerned with preventing lending rates from falling than with seeking out new borrowers. Looking ahead, the fuel price increases which were almost certainly in prospect, and which would be felt throughout the economy, might provide the psychological basis--if nothing else--for greater efforts to raise product prices rather than to expand sales at current prices. While monopolistic influence on prices was not new, it seemed to him that there was more of it now than in the past. If that were true, it could seriously retard the recovery.

In reply, Mr. Partee said he had no direct information on the question of whether there had been an increase in monopolistic tendencies. However, the fact that the rate of inflation now was lower than had been expected 6 months ago tended to argue that there had not been. Indeed, some rather large price reductions were now occurring, at least temporarily. He might mention that the most notable case of monopoly power that had recently received attention in the press was in the area of State and local government employment; municipal workers were refusing to accept the necessity either of layoffs or of any change in the pattern of wage increases, and they were prepared to strike to win their point.

Chairman Burns asked whether some branches of the construction industry should not be mentioned also.

Mr. Partee agreed. He added, however, that it was difficult to determine the level of wages that was actually being paid in that industry. The fact that the bids received on many construction contracts were lower than expected suggested that some concessions from nominal wage rates were being made.

More generally, Mr. Partee continued, he might note that retail merchants appeared to be conducting an unusual number of promotional sales this year; the automobile industry had been offering rebates of one kind or another more or less continuously; some appliance manufacturers also had developed rebate programs in the spring; textile prices had broken; and apparel prices had broken. Those developments suggested an encouraging response to market forces rather than an increase in monopolistic practices.

On the whole, he doubted that there had been much change in the importance of monopolistic practices since, say, the 1950's, when the steel industry had been raising prices regularly, regardless of their rate of capacity use or other presumably relevant considerations.

However, Mr. Partee observed, he was concerned about one possibility Mr. Baughman had mentioned--that coming fuel price increases would provide an occasion for widespread advances in product prices. Many businessmen felt that they needed a rationalization in order to raise their prices. Traditionally, they had used wage increases for the purpose, but in the period ahead they would also be able to use rising fuel costs. An improvement in profit margins might well occur in the process of passing on increases in fuel costs.

Chairman Burns said he might mention in connection with Mr. Baughman's question the recent postponement of an announced increase in the price of aluminum, following intervention by the Council on Wage and Price Stability. The original increase might be rescinded or, more likely, scaled down. For some reason, the Council had been less active in recent months than it might have been, but he would not be surprised if it became more active in the months ahead.

Mr. Winn observed that he was somewhat concerned about the financial underpinnings for a recovery in real activity. Under almost any reasonable assumptions, there would be disintermediation at financial intermediaries by the end of the year, and that would have serious adverse effects on the housing industry. Also, it appeared that bank examiners were now suggesting loan write-offs on a much larger scale than, say, 3 months ago.

The Chairman said it had been his impression that banks were adding substantially to their loss reserves and, at the same time, were experiencing a rather sharp increase in profits.

Mr. Winn agreed. His concern was that the tremendous increase in loan write-offs being suggested by examiners would reduce the willingness of banks to lend during the economic expansion.

A discussion of current bank examination practices then ensued, during which it was noted that banks were required to write off only those loans classified as "loss." The treatment of loans classified as "doubtful" and "substandard" was discretionary with the banks, although examiners might recommend write-offs of some loans in those categories. Instances were noted in which Federal Reserve officials had met with boards of directors of banks to encourage increased provision for loan losses.

Following this discussion, Mr. Winn asked whether it might not be desirable to begin considering the possibility of raising the Regulation Q rate ceilings at this time, rather than waiting until the ceilings were posing a serious problem.

Chairman Burns remarked that Mr. Winn's suggestion was a reasonable one. While he doubted that it would be possible to get agreement among the regulatory agencies on an increase in the ceilings now, he thought the question should be pursued. Noting that Mr. Mitchell, the System's representative on the Inter-Agency Coordinating Committee on Bank Regulation, was absent today, he asked whether Mr. Bucher, who served as alternate to Mr. Mitchell in that capacity, would hold informal conversations with the representatives of the other agencies to determine their attitude.

Mr. Bucher agreed to do so.

Mr. Balles referred to Mr. Partee's concluding observation in his statement earlier today to the effect that there were ample unused productive resources to support substantially higher levels of output. One possible implication of that statement was that the Committee should try to accelerate the rate of economic recovery. Subsequently, Mr. Morris had made such a suggestion in connection with his pertinent observations about the need to develop a longer-term strategy for policy.

After participating in discussions on that general subject at his Bank, Mr. Balles continued, he was inclined to take issue with such a view. In analyzing what might be termed the "fast recovery scenario" and the "slow recovery scenario," he had arrived at a few tentative conclusions based on some judgments about the lessons of history. A more stimulative policy, designed to insure a rapid recovery, would have the obvious advantage of reducing unemployment more rapidly. On the other hand, the so-called fast recovery scenario could lead to a higher rate of inflation than the slow recovery approach. If that were the case, then the rapid recovery approach would not necessarily lead to faster real growth or lower unemployment over the longer run.

That judgment was supported by developments after the 1960 recession, Mr. Balles observed. As the members would recall, the recovery then was slow, but it was balanced and sustained, and it was not marked by severe pressures on prices or the balance of payments. As a result, the nation enjoyed about 6 years--until the escalation of hostilities in Vietnam--of uninterrupted growth and prosperity. In contrast, one might consider the experience following the 1970 recession, the most recent example of an attempt at rapid recovery. Unemployment did decline more quickly than after the 1960 recession but there also was a more rapid buildup of excess demand pressures that required a reversal of policy rather soon.

Mr. Balles said he certainly appreciated the positions of those who thought that the current level of excess capacity would permit a more aggressive expansionary policy. He doubted the wisdom of pursuing such a policy, however, for three reasons. First, stimulative U.S monetary actions could have a strong "demonstration" effect on the economic policies of other countries. If all major industrial countries were to start pursuing aggressive expansionary policies now, he would anticipate a repetition of the sequence of the early 1970's, in which a worldwide expansion was followed by worldwide inflation, by widespread adoption of restrictive economic policies, and by a worldwide recession. Secondly, rapid rates of monetary growth are not easy to reverse, particularly if unemployment is still high. If the Committee were to embark now on a course calling for growth in M_1 at an 8 to 10 per cent rate and found at the end of 1976 that the unemployment rate was still above 8 per cent--the level now projected by the staff--it would have real difficulty in slowing M_1 growth. Finally, a fine-tuning of money supply growth had not been easy to achieve in the past, and while he might be unduly pessimistic on the matter, he saw no reason to think it would be any easier to achieve in the future.

In sum, Mr. Balles observed, at least on the basis of a tentative analysis of the fast versus slow recovery scenarios, he favored a slower recovery--at a rate consistent with expansion in M_1 over the next 12 months in the 5 to 7-1/2 per cent range which the Committee had agreed upon at recent meetings. He thought a faster growth would risk a repetition of the past 5 years' experience.

Mr. Bucher noted that, according to the green book, "The long-awaited upturn in residential construction activity now seems firmly under way." Mr. Partee had also mentioned evidence of that upturn in his statement earlier today. However, the summary chapter in the red book,[1] after mentioning "scattered reports of increased construction activity," went on to say that "home building remains weak throughout the country and will be slow to recover." That difference in view among the staff reports was one of the most marked that he could recall, and he wondered about the reasons for it.

In reply, Mr. Partee said the explanation might simply be that staff at the Reserve Banks and the people with whom they spoke expected a less vigorous recovery in housing than the Board staff did. While there were continuing problems in the area of multi-family units, the Board staff thought the signs had become increasingly favorable for construction of single-family units. He had been somewhat surprised to find so little indication of that improvement in the various District reports in the red book.

Mr. Black said he thought the difference could be explained by the fact that to an important extent the views expressed in the red book reflected those of the Reserve Bank directors. It was his impression, based partly on experience with the directors of his Bank, that businessmen and bankers were less willing than economists to

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

rely on expected developments in reaching judgments about the economy; they preferred more tangible evidence.

Chairman Burns agreed that that probably was at least part of the explanation. Attitudes of Reserve Bank directors regarding the outlook for housing were no doubt based mainly on observable activity, whereas the staff was taking account of the implications of savings flows and mortgage commitments at thrift institutions. He might note in that connection that new mortgage commitments at S&L's had risen from about $1 billion last November to approximately $4 billion. It was also possible that the directors were not taking account of the implications of the recent housing legislation. It was true that the effects of that legislation were particularly difficult to evaluate; two industry experts, with exactly the same information before them, could easily arrive at rather different judgments.

Mr. Partee remarked that there was one observable fact--the recenc rise in merchant-builder sales of new homes--that he would have expected to see reflected in the comments expressed in the red book. As noted in the supplement to the green book, such sales had risen from a rate of about 400,000 in January to over 575,000 in May. That was a substantial increase.

The Chairman observed that the supplement also included figures on the median prices of new and existing homes sold. He had been astonished by the rapid increases shown for recent months; according to his calculations, from January until May the median price advanced at an annual rate of about 22 per cent for new homes and at a rate of about 18 per cent for existing homes. Those figures seemed incredible, and he wondered what they meant. Was the rapid advance a consequence of the tax credit on home purchases provided by the recent housing legislation? Or were the figures simply wrong?

Mr. Solomon suggested that at least part of the explanation might lie in a shift in the composition of homes sold toward more expensive units.

Mr. Partee noted in that connection that, as indicated in the green book supplement, the median price of new homes sold in May was $3,000 above the median price of unsold new units. Last summer and fall, the reverse was true: the median price of homes sold was below that of unsold units. Thus, there had been a shift recently toward purchases of more expensive homes. That development might very well be a consequence of the recently enacted tax credit.

Mr. Jackson remarked that one factor affecting house prices was the philosophy of many builders that "you can't build a house any cheaper." That attitude was, of course, fundamentally foolish, since it assumed that building lots would be of the customary size, that customary architectural plans would be followed, and that customary materials and supplies would be used. During the 1973-74 collapse in the market for single-family homes, prices had continued to rise dramatically as a result of cost increases, and in 1974 the market finally rebelled against the advances.

Turning to the more general issue, Mr. Jackson said he expected the rising curve of housing starts to begin flattening out soon, primarily because the increase was concentrated in single-family homes whereas the surges in previous years had been in second homes, including recreational condominiums, and in multi-family units. There was no question that recent sales of single-family units had been excellent, but he saw very little fundamental economic support anywhere in the country for substantial increases in multi-family units. Such factors as rent controls and changing legal relationships between landlords and tenants were likely to discourage many projects that might otherwise appear viable. And finally, commercial banks were likely to be reluctant to make construction loans for multi-family units unless they had extremely strong reasons for expecting repayment in timely fashion.

Mr. Coldwell said he had only one comment regarding the current economic situation: he was rather nervous about starting a recovery with long-term interest rates as high as they were at present.

Chairman Burns remarked that most members would share that concern. He might note, however, that the rate of inflation had something to do with the current level of long-term interest rates.

Mr. Coldwell said he recognized that fact. He also recognized that with rates at their present levels disintermediation was likely to develop sooner than otherwise and the reluctance to borrow, on the part of both consumers and producers, would be greater.

Mr. Mayo remarked that like Messrs. Coldwell and Winn, he was concerned about the possibility of disintermediation, given the effects it would have on housing activity. Little or nothing had been said today about REIT's, although that subject was related to the question of classified bank loans touched on earlier. Something approaching media and public euphoria appeared to have developed in connection with bank loans to REIT's. While it was true that some of the housing units financed through REIT's had been sold recently, he had the impression that there was still a serious overhang of unsold units. He would be interested in Mr. Partee's opinion regarding the present situation with respect to REIT's.

In reply, Mr. Partee expressed the view that there had been no improvement whatsoever in the underlying situation with respect to REIT's. An official of a REIT trade association had advised him a few days ago that the proportion of delinquent loans was as high as formerly and in fact was still rising. The number of loans that had been renegotiated by banks to reduce interest rates or to forgive or defer interest income was now quite large. And a new concern was emerging. To an important extent, the structures involved were a highly specialized form of housing, including resort and development housing in such areas as the Florida and Gulf coasts and in south Texas. Because there had not been any significant improvement in the market for such properties, a large number had never been carried to completion, and the uncompleted structures were now depreciating rather rapidly as a result of vandalism and the effects of weather. Not only was the REIT situation bad; it was gradually worsening.

The Chairman referred to Mr. Partee's comment about the number of bank loans to REIT's that had been renegotiated, and said he would consider the fact that the problems were being worked out in that way to be a favorable development.

Mr. Kimbrel said he was not sure the problems were being worked out as smoothly as one might think. The Comptroller's office was now following a new procedure under which form letters were sent to all banks participating in loans of $20 million or more that had been classified by examiners at the lead bank. The participating banks were required to charge off any loans classified as loss even before they themselves were examined. It was his impression that banks in the Sixth District were becoming uneasy about REIT loans on their books, and to protect their own positions many were considering legal actions of a kind that would increase the chances of bankruptcy on the part of the REIT's involved.

Mr. Mayo said he was not familiar with the use of REIT's in Southern resort areas. However, he had heard reports that in Chicago, Milwaukee, and other parts of the Seventh District large numbers of the structures involved were being completed and some were being sold, although sales admittedly were very slow. It was his impression, however, that such developments were exceptional rather than general.

Mr. Debs remarked that he certainly had not detected any euphoria in connection with the REIT situation. However, he did note some sense of satisfaction with the adjustment process that banks had carried out over the past several months; in effect, they had coped with the problem by making provision for losses. In contrast to the widespread expectation 6 to 12 months ago that the whole REIT industry would collapse at one time in a domino pattern, it had become possible to spread the losses out.

Chairman Burns observed that pressures for a new RFC or other Governmental unit to assist the REIT's had diminished dramatically in the past few months. No doubt that was largely because the banks seemed to be working the problems out, if perhaps in clumsy fashion.

Mr. Debs added that banks were, in effect, transforming a loss of assets into a reduction in earning power. At the same time, their over-all profits were rather good.

Mr. Mayo remarked that he was concerned about the exposure of the purchasers of the properties in question at the time when interest rates began to rise again.

Mr. Partee commented that the industry was hoping for an improvement in consumer sentiment that would lead to a revival of interest in resort and recreational properties, even though mortgage interest rates might be somewhat higher than they were now.

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 17 through July 9, 1975, and a supplemental report covering the period July 10 to 14, 1975. Copies of both reports have been placed in the files of the Committee.

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

> The period since the June meeting of the Committee has been marked by a number of crosscurrents that have produced significantly higher short-term interest rates and somewhat higher intermediate- and long-term rates. Early in the interval pursuit of the Committee's moderate

monetary growth objectives caused the Account Management to take action to firm money market conditions as weekly data showed sharply higher growth in monetary aggregates than was desired. The Desk aimed at the outset for reserve conditions consistent with a Federal funds rate in the 5-1/2 per cent area, where it had been around the time of the June meeting. As early as June 20, however, it appeared that monetary growth in June was excessive and the Desk acted to make clear the System's desire for firmer conditions--executing matched sale-purchase transactions in the market when funds were trading around 5-1/2 per cent and market participants were anticipating that, if anything, there was a need to add rather than to absorb reserves.

In making its firming move the Desk first sought a funds rate around 5-3/4 per cent. However, another week of strong data for the aggregates suggested even greater over-runs for the June-July period and the Desk raised its aim to a funds rate around 6 per cent, the top of the range specified at the June meeting. In further response to the strong growth, a majority of the Committee members agreed with the Chairman's recommendation on June 26 to raise the upper limit of the funds range to 6-1/4 per cent, with the understanding that this higher level would be sought if new data gave further evidence of excessive monetary growth. As it turned out, the more recent monetary data have calmed down considerably, and the Desk has retained a 6 per cent objective. However, in the final days of June and early July, when seasonal pressures in the money markets augmented the upward thrust in the funds rate encouraged earlier by the System, funds traded for several days in the area of 6-1/4 to 6-5/8 per cent. In the last few days, while the objective remained 6 per cent, funds have traded mainly a shade under that level.

Very sizable short-term operations--repurchase agreements and matched sale-purchase transactions--were again used to cope with reserve variations imposed by large swings in the Treasury balance. However, during the period of build-up in Treasury balances in late June, advantage was taken of the resultant reserve need to buy nearly $800 million of Treasury coupon issues. Outright holdings of bills declined over the period; purchases in the earlier part were roughly offset by subsequent sales, but the Desk ran off $400 million of bills in yesterday's auction.

Interest rates rose sharply in late June as market participants sensed the System's less accommodative posture and also reacted to the reemergence of heavy Treasury borrowings. More recently, the markets have steadied as participants concluded that the System seemed satisfied for the present with a funds rate around 6 per cent. Publication of weekly declines in money supply and business loans reinforced these sentiments.

Although the recent rate moves were large, the market displayed considerable resiliency as the emergence of higher yields fostered dealer and customer demands that enabled the Treasury to resume its cash-raising after running through the bulge of June tax receipts. The next major task of the Government securities market, following an auction of $1.5 billion of 2-year notes on July 17, will be the August refunding--possibly accompanied by net cash raising--to be announced on July 23. The public holds some $4.8 billion of the August 15 issues, and the market expects that perhaps another $1 billion or so of cash might be raised. The System has nearly $2.6 billion of the maturing August notes, and we would expect to exchange these for new issues in about the same proportion as such issues are offered to the public.

Aside from new Treasury offerings, another cloud over the Treasury and agency markets is the threat of possible liquidation of holdings by, or on behalf of, a certain corporation that had amassed large positions on apparently very thin margins. This corporation, with security holdings and liabilities in excess of $1 billion, was placed in the hands of a receiver last week, and there is now somewhat more confidence that its affairs can be unwound in an orderly fashion. However, there is still uncertainty.

Finally, while mentioning clouds over the market, it may be noted that the Municipal Assistance Corporation established to aid New York City sold a $1 billion issue in the recent period, but the sale required very high rates and the bulk of the issue went to investors who felt a public responsibility to help. Subsequent issues may be harder to place, and still greater difficulty is anticipated when "Big Mac" exhausts its legal borrowing authority and the City seeks to return to the market in its own name.

In reply to questions, Mr. Sternlight indicated that "Big Mac" had a legal borrowing limit of $3 billion. There were indications that the City would need to borrow some $5 billion beyond that amount.

Chairman Burns said he had heard earlier that the amount of borrowing in excess of the limit might be about $3 billion. He found the situation to be somewhat discouraging.

Mr. Partee observed that New York City was continuing to incur deficits in its operations.

Mr. Morris said he wanted to compliment the Manager on his skillful operations over the past month. It had been demonstrated, he felt, that a major change in money market rates could be implemented without the adverse consequences that were sometimes feared by some Committee members.

Chairman Burns observed that the compliment was well deserved. He would question, however, whether the recent change in money market rates could be described as major. That, of course, was a matter of opinion.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period June 17 through July 14, 1975, were approved, ratified, and confirmed.

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

The alternatives[1] presented in the blue book[2] for FOMC consideration, in terms of effects on the money market, run the spectrum from some easing to some tightening between now and the next Committee meeting. Alternative B calls for maintaining about prevailing money market conditions, with the funds rate range centered on 6 per cent.

I should emphasize, though, that we have worked out the relationship between the Federal funds rate and longer-term money growth in the blue book on the additional assumption that the Federal funds rate would be higher later in the year. We now appear to be at the beginning of a cyclical upswing in economic activity that might involve relatively substantial increases in the demand for money. Our staff projection is for a 13 per cent annual rate of increase in nominal GNP over the second half of 1975. Given this projection, if the funds rate is kept unchanged at around 6 per cent over the next 4 weeks, as under alternative B, we believe that it would have to rise to the neighborhood of 8 per cent by fall if the supply of money is to be kept on a path consistent with the FOMC's longer-run objectives for the monetary aggregates. The eventual increase in the funds rate needed to constrain the aggregates may be somewhat less if some rise were permitted over the next 4 weeks--as under alternative C--and the additional monetary restraint thereby put in place a little earlier.

While all of the short-run operating alternatives are presented within the framework of the longer-run targets for the aggregates decided on by the Committee at its last meeting, there is some ambiguity in interpreting the longer-run targets because of the unexpectedly rapid growth of M_1 in June. As you will recall, the FOMC decided on a longer-run growth rate for M_1--stated in terms of mid-points--that was 6-1/4 per cent from June 1975 to June 1976. The base level for June 1975 at the last meeting had been estimated; data had been available, even on a partial basis, only for the first third of the month. As explained in the current blue book, the relatively complete data for June now indicate that the level of M_1 for the month is \$1.7 billion higher than earlier estimated--

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

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

an increase that amounts to a little more than 1/2 per cent of the outstanding money stock. One interpretation of the FOMC's decision at the last meeting would be that the Committee wished to attain the target level of M_1 by June 1976 that was implied by a 6-1/4 per cent growth from the old June base. On this interpretation, M_1 growth from the upward revised June base would then have to be about 5-3/4 per cent rather than 6-1/4 per cent.

The June 1976 figures for the monetary aggregates shown in connection with alternatives B and C are consistent with this interpretation. It should be noted that the resulting growth in M_1 measured from the average level of the money stock outstanding over the whole second quarter of 1975--that is, growth measured from that quarterly average rather than from the monthly average--to the average level outstanding during the second quarter of 1976 is in fact around 6-1/4 per cent under these assumptions.

Another interpretation of the Committee's decision is shown in connection with alternative A. There we have assumed a 6-1/4 per cent growth in M_1 over the next year from the June 1975 base level as currently estimated. As a result, M_1 would remain about $1.8 billion higher than was implied by the FOMC's decision at its last meeting, but the growth rate from June 1975 to June 1976 would be the same--6-1/4 per cent.

There is a certain logic in associating this latter interpretation with an easing of the money market in the weeks ahead--on the view that if the Committee were willing, in effect, to "forgive" the June overshoot, it may also wish to consider restoring the easier money market conditions that prevailed earlier. However, there is no necessary relationship between the various short-run money market specifications presented to the Committee and how the Committee may in fact wish to interpret its longer-run objective for M_1. The alternative Federal funds rate ranges presented to the Committee could be construed to go with either of the interpretations of the longer-run objective for the monetary aggregates. The principal effect would instead be on the behavior of short-term interest rates later this fall, not on short-term interest rates in the 4 weeks immediately ahead--with the size of the upward adjustment in short rates later this fall inversely related, of course, to the amount of reserves and money the Committee seeks to supply.

Chairman Burns noted that at its April meeting the FOMC had agreed upon certain ranges of growth for monetary and credit aggregates, including a range for M_1 of 5 to 7-1/2 per cent, for the period from March 1975 to March 1976. He had reported that decision to the Senate Banking Committee in hearings held on May 1--the first hearings conducted pursuant to the Concurrent Resolution on monetary policy recently adopted by the Congress. Upon reviewing the growth ranges at its June meeting, the FOMC had decided to retain the numerical ranges that had been agreed upon in April, but to shift forward the interval to which they applied by 3 months--that is, to the period from June 1975 to June 1976.

In his judgment, the Chairman observed, the Committee's decision in June to retain the numerical ranges it had agreed upon earlier was correct; to have changed them so soon after they had been initially adopted would have caused a great deal of confusion within the Congress and in the business and financial community. For the same reason, he would not propose any revisions in the numerical ranges today. He would, however, suggest another kind of modification--namely, to define the growth rates in terms of changes between average levels in calendar quarters rather than calendar months. Specifically, he would suggest that the 5 to 7-1/2 per cent range for M_1, and the corresponding ranges for the other aggregates, be interpreted as applying to the period from the second quarter of 1975 to the second quarter of 1976, rather than from June 1975 to June 1976. The shift would have some implications for the implied levels of the aggregates in the month of June 1976, but they were minor.

The reason for his proposal, Chairman Burns continued, was the great volatility of monthly figures for the monetary aggregates. That volatility had been illustrated most recently in the figures for June, when the growth rate for M_1 had proved to be the highest on record and considerably higher than estimated a month ago. Quarterly averages were, of course, more stable than monthly figures. He now believed that quarterly averages should have been employed originally, when the one-year growth ranges were decided upon at the April meeting. If the FOMC now agreed to shift to a quarterly basis, he would report that fact in his testimony before the House Banking Committee scheduled for July 24.

The Chairman added that if the FOMC agreed to use a quarterly base, it should plan on holding to that decision; to shift back and forth between monthly and quarterly bases would be highly undesirable. Of course, unforeseen circumstances might arise under which it would be considered useful to supplement growth ranges on a quarterly base with corresponding figures on a monthly base.

Mr. Eastburn said he agreed with the Chairman's suggestion. He added that revisions in the estimated levels for the base period used to calculate growth ranges were likely to be a perennial problem. For that reason he would suggest that when the FOMC next reviewed its longer-run targets, it consider specifying those targets in terms of the levels desired at the end of the period rather than in terms of percentage rates of growth over the period.

Chairman Burns expressed the view that it would be helpful to use levels in conjunction with growth rates.

Mr. MacLaury said he would endorse the use of a quarterly rather than a monthly base. Also, he agreed with Mr. Eastburn that the targets should be expressed in terms of desired levels, in order to avoid the problem of revisions in the figures used as the base for expressing growth rates.

Mr. MacLaury went on to note that in his statement Mr. Axilrod had described alternatives A and C as involving, respectively, some easing and some tightening "in terms of effects on the money market." In deciding whether a particular alternative involved easing or tightening, he would prefer not to focus exclusively on money market conditions but to give at least equal weight to the aggregates.

Mr. Axilrod observed that in the present instance the two sets of criteria happened to warrant the same descriptions.

Mr. Coldwell referred to the Chairman's statement that a shift to a quarterly base would have some implications for the implied levels of the aggregates in June 1976. He asked about the nature of those implications.

Mr. Partee said he might mention one consequence of the proposed shift. If the Committee were to retain the previous percentage growth ranges for the June-to-June period but apply those percentages to the current estimates of June 1975 levels, the levels implied for June 1976 would be higher than contemplated at the last meeting because the current estimates of June 1975 levels were higher than those of a month ago. If, however, the growth ranges were interpreted as referring to the change between the second quarters of 1975 and 1976, the levels implied for June 1976 would be brought closer to those the Committee had contemplated a month ago.

The Chairman said it might be helpful if he were to expand on Mr. Partee's observation, using some figures the staff had calculated at his request. The figures reflected the levels of M_1 in the month of June 1976 that were found by applying a growth rate of 6-1/4 per cent--the midpoint of the 5 to 7-1/2 per cent range--to different bases. In March 1975, the base month used for the original one-year growth ranges, M_1 was \$286.1 billion. If in June the Committee had agreed upon a 6-1/4 per cent growth rate through June 1976 measured from that March 1975 level, the level implied for June 1976 would have been \$308.5 billion. At the June meeting, however, the Committee decided to measure its growth ranges from a June 1975 base, thus continuing to use a 12-month period rather than lengthening the period to 15 months. At the time of the June meeting, M_1 in June was estimated at \$292.4 billion--a level higher than would have been reached if M_1 had grown from March to June at a 6-1/4 per cent rate. Using the then-estimated June 1975 level as the base, a 6-1/4 per cent growth rate over the ensuing 12 months would have yielded a level in June 1976 higher than \$308.5 billion--specifically, \$310.7 billion.

At present, Chairman Burns continued, M_1 in June was estimated at \$294.1 billion, and a 6-1/4 per cent growth rate over the ensuing 12 months would yield a June 1976 level of \$312.5 billion. However, since the average level of M_1 in the second quarter of 1975 was below that in June 1975, use of the quarterly average as a base would reduce the implied June 1976 level--to \$310.0 billion. That was a shade below the corresponding level contemplated at the previous meeting, but it was still somewhat above the level that would have been implied had the 6-1/4 per cent growth rate been calculated from the original March 1975 base.

In reply to a question by Mr. Balles, the Chairman said his proposal was to employ quarterly averages for both the starting and terminating figures in calculating growth ranges. In the calculation he had just cited, which used the second quarter of 1975 as a base, the implied level had been derived for June 1976, rather than for the second quarter of 1976, only to maintain comparability with the other June 1976 figures he had mentioned.

Mr. Holland observed that the Chairman's proposal would respresent a salutary resolution of a difficult current problem. It would also establish a procedure that, he thought, would serve the Committee well in the future.

Mr. Coldwell asked whether a shift to a quarterly base would not, in effect, reduce the implied June 1976 level for M_1 by $2-1/2 billion.

Chairman Burns commented that the $2-1/2 billion reduction would not be from the June 1976 level that the Committee had had in mind, at least implicitly, at the time of the June meeting. That level implied a reduction of only $0.7 billion.

To illustrate more fully the implications of his proposal, the Chairman continued, he would cite some of the growth rates for the 15-month period from March 1975 to June 1976 that were implied by use of the different bases he had mentioned. If the level for M_1 as estimated at the time of the June meeting were used as the base, a 6-1/4 per cent rate of growth from June 1975 to June 1976 would imply a 7 per cent rate of growth over the longer 15-month period. If the June level of M_1 as currently estimated were used as the base, the implied rate of growth over the 15-month period would be 7-1/2 per cent. If the average level in the second quarter of 1975 were employed as the base, the implied growth rate over the 15-month period would be 6-3/4 per cent. All of those results were within the Committee's 5 to 7-1/2 per cent range, and in his judgment, they involved fine shadings that--in light of the errors of estimation that had been made in the past and doubtless would continue to be made--were not really significant. The important consideration, in his view, was the establishment of a more stable base.

In response to a further question by Mr. Coldwell, Chairman Burns noted that the use of the second-quarter average as a base would imply an M_1 level in June 1976 that was $1-1/2 billion higher than the level obtained by applying a 6-1/4 per cent growth rate to the initial March 1975 level.

Mr. Morris said he thought the change proposed by the Chairman was desirable. He expressed the hope that future blue books would reflect the new approach.

Chairman Burns indicated that the staff was prepared to proceed on the new basis. He then asked whether there were any objections to his proposal, and none was heard.

Mr. Eastburn referred to his earlier comment that translating the one-year growth rates into levels would serve to obviate much of the problem. He suggested that the Committee plan on using levels the next time it deliberated on longer-term targets.

Chairman Burns replied that while he was inclined to favor the use of levels, he did not think the Committee should reach a decision at this time. He wanted to give the matter more study, and other members no doubt felt similarly. However, he would ask the staff to incorporate information on levels as well as on growth rates in the blue book.

Mr. Debs commented that if the Committee shifted to the use of levels there would no doubt be frequent requests for the implied growth rates.

Mr. Holland observed that the Committee's experience with similar--if less important--problems in connection with the short-run specifications for the aggregates suggested that reference to levels offered a means for resolving difficulties arising in connection with target growth rates.

Mr. Holland then said the staff should remain alert to the possibility that the Committee might want to use changing growth rates within the one-year ranges for policy purposes. The staff tended to employ the midpoints of the ranges as indications of the Committee's policy objectives, and to view the ranges themselves as a means for dealing with estimating errors. He wanted to make it clear, however, that he, for one, intended to use the ranges for policy purposes between now and the second quarter of 1976, at least if events unfolded in the manner he now expected.

Mr. Wallich asked if the blue book would include data on levels of aggregates corresponding to the upper and lower limits of the growth ranges as well as the midpoints.

Chairman Burns said he would prefer to have any such data shown in an appendix, where it could be studied or ignored, as individual members preferred. The blue book was tending to become increasingly technical, and while that made for a fine scholarly document, there was a risk of diverting the Committee's attention from broad policy considerations to debates on technical matters. In fact, the staff might give some thought to simplifying the blue book by relegating to appendixes some types of material now included in the body of the text.

The Chairman then called for the discussion of monetary policy and the Committee's policy directive. He suggested that the members focus initially on the broad direction of policy without reference to numerical specifications.

Mr. Mayo commented that he considered the current course of policy to be about right. Like Mr. Coldwell, he had hoped that the recovery could start with lower short- and long-term interest rates than were now prevailing. Nevertheless, he thought that, with the aid of the Desk's skillful operations, the transition to a 6 per cent Federal funds rate had been achieved smoothly and without any market dislocation. Moreover, the signs of recovery--and in the Midwest, at least, they were no more than signs--were sufficient to justify a 6 per cent funds rate target at this time.

Therefore, Mr. Mayo said, he would maintain the current policy course for the period immediately ahead. He would not hasten to adopt a more restrictive policy today in the expectation that that would make the Committee's task less difficult in, say, a year from now. If, as he expected, the recovery was a slow one--and like Mr. Balles, he would consider that desirable--a policy aimed at little change in interest rates over the next month would be appropriate.

Mr. Leonard remarked that his view of monetary policy actions had consistently been based on the premise that the long-run trend growth of money determined the long-run trend in prices, and that variations of money growth from its trend were associated with fluctuations in output, employment, and short-term interest rates. Over the past five years the trend rate of growth in M_1 had been about 6 per cent per year.

Mr. Leonard noted that a substantial amount of front-end loading in the aggregates had occurred in the past few months. In his judgment the consequences of sharply reducing the rates of growth in the monetary aggregates by the first half of 1976--in order to achieve the Committee's longer-run growth objectives--had not been sufficiently emphasized in the blue book. There was no question in his mind but that such action would have an adverse impact on real GNP and employment. Moreover, additional front-end loading now would necessitate a still sharper cutback next year, with consequences for the real economy that would be even more undesirable. He felt that the specifications of alternative C would provide a smoother path toward the Committee's longer-term objectives because they would require less of a reduction in the growth of the aggregates during the first half of next year.

Mr. Morris said he favored maintaining about the prevailing level of money market rates until more information became available on the likely growth of the monetary aggregates at such a rate level. Accordingly, he preferred the short-run specifications of alternative B; the M_1 growth rate for the coming 6 months associated with that alternative--7 per cent--seemed appropriate to him also. Nevertheless, he was concerned that such a course would provide little leeway in the first quarter of 1976 for action aimed at achieving growth in the monetary aggregates within the one-year growth ranges reported to the Congress.

The Chairman said it was important to keep in mind that the Committee's fundamental objectives concerned the state of the economy. As Mr. Morris had suggested earlier, the Committee should never seek to attain specific growth rates for the aggregates without regard to the requirements of the economy. The language of the Concurrent Resolution clearly indicated that the FOMC was free to modify the one-year growth ranges as changing conditions dictated. That language should be taken seriously; if the Committee decided that the longer-run growth ranges agreed upon earlier no longer met economic requirements as the members assessed them, it should modify those ranges without regard for any criticism that might result. The Federal Reserve would be criticized no matter what policy course it followed.

Mr. Morris then observed that at the last meeting of the Committee he had advocated higher ranges for the longer-term targets. For one thing, he thought higher ranges would be necessary to provide adequate elbow room for operations during the first half of 1976. Secondly, although he realized the Committee had to be free to depart from the ranges it had agreed upon if economic conditions should so require, he thought the credibility of the Federal Reserve was at issue.

In that regard, Mr. Morris continued, he had been concerned about the conclusion of the recently published report of the

Congressional Budget Office that money supply growth within the Committee's published target ranges would not be adequate for the economy but that the Federal Reserve would recognize the insufficiency and allow M_1 to grow at a rate of about 8-1/2 per cent over the next 18 months. That report was representative of the problem of maintaining the credibility of the Federal Reserve with Congress. In his judgment, narrow ranges for the aggregates--allowing too little leeway on the upside--could involve a price in terms of the System's Congressional relations.

Chairman Burns said it was possible that a problem with Congress would arise. He might note, however, that the recent report of the Senate Banking Committee had strongly endorsed the target ranges adopted by the FOMC. He found that endorsement quite encouraging.

Mr. Clay said he favored a monetary policy that would accommodate a sustainable economic recovery, and he was pleased that the Committee's longer-term monetary targets appeared to be consistent with the achievement of that objective. Although he would like to see a vigorous recovery, he thought the slower recovery in propsect would foster improvement in productivity and would benefit the nation in the long run.

In that regard, Mr. Clay continued, some of the benefits of increased productivity had become apparent in the Kansas City area. The past decade had been a difficult period for the local construction industry. Wages in that industry had risen more rapidly than wages in other local industries and work attitudes had been poor. Consequently, contractors had been losing money on the labor component of their contracts. Since last fall, however, there had been real gains in productivity; the workers' increased reluctance to strike and their awareness of the limited opportunities to gain temporary employment elsewhere had resulted in significantly better performance on the job. The rise in productivity had benefited the local economy, through substantial new construction in process and more productively employed workers.

Turning to the specifications for monetary policy, Mr. Clay expressed the view that a 6 per cent rate of growth in M_1 during the second half of 1975 would be desirable. The achievement of that growth rate probably would require some gradual upward movement in short-term interest rates over the period. However, in light of the recent sharp rise in short-term rates, he would be cautious about any substantial further increase in the next few weeks. He feared that if M_1 were to grow in the latter half of 1975 at the 7 per cent rate mentioned by Mr. Morris, it would be difficult to slow growth sufficiently in early 1976 to achieve one-year growth rates within the ranges announced by the Committee.

Accordingly, he preferred the short-run specifications and directive language of alternative B, and the 6-month targets for the aggregates of alternative C.

Mr. Wallich observed that two significant developments of the past month were the rapid expansion of the money supply--primarily as a result of special Treasury disbursements--and the sharp rise in interest rates. Fortunately, the passage to a higher level of interest rates had been rather smooth.

While he had not expected such an interest rate adjustment this early, Mr. Wallich said, he would not favor seeking lower rates now. The blue book projections of growth in the monetary aggregates in the July-August period implied a rate of about 10 per cent for M_1 in August. That seemed very high to him, and he also was concerned about the risk of unduly rapid monetary growth in subsequent months. In his judgment, there was some basis for the conclusion reached by the Congressional Budget Office that the Federal Reserve was likely to allow a higher rate of growth in M_1 than presently targeted. Personally, he saw no reason for giving up; as he had said repeatedly, the Committee could not in good conscience yield to pressures for unduly rapid monetary growth. Accordingly, he would bite the bullet now and begin to move toward a moderately tighter policy--as close to the alternative C specifications as feasible. He would not, however, want to see the funds rate go as high as 7-1/4 per cent; he would prefer a range for that rate about midway between the 5-1/2 to 6-1/2 per cent range of alternative B and the 6-1/4 to 7-1/4 per cent range of alternative C.

Mr. Debs remarked that the basic background for today's decision was similar to that of a month ago. In the process of choosing longer-term targets at that time, the Committee had considered the likely consequences--including the rate of growth in GNP--of alternative paths for the aggregates. After taking account of the prospects for inflation on the one hand and unemployment on the other, the Committee had decided to aim for a moderate recovery in the hope of avoiding the extremes in both. He thought that decision had been correct, and he continued to feel comfortable with the longer-range targets adopted at that time.

Since the last Committee meeting, Mr. Debs continued, there had been additional evidence of an upturn in economic activity, moderate though it might be. Although unemployment was high and was expected to remain so, price developments in recent months had been rather favorable. He was concerned, however, about the impact of oil price increases and about the possible surge in inflationary expectations that might be generated by the sale of wheat to the Soviet Union.

Turning to the financial situation, Mr. Debs observed that, while growth in the monetary aggregates in June had been much stronger than anticipated, it had clearly been quite weak thus far in July. He shared the view that a decline in the Federal funds rate would not be desirable at this time, particularly in light of the probable need for some increase over the months ahead. Under the circumstances, a reduction in the funds rate now would be misleading and confusing. Taking into account the likelihood of weakness in the monetary aggregates in July, he would set the lower limit of the July-August ranges for the aggregates low enough to avoid triggering a decline in the funds rate. He thought specifications somewhere between those shown for alternatives B and C would meet his policy prescription.

Mr. Black said he concurred in the decisions today to formulate the longer-run targets for the aggregates in terms of quarterly average levels and to retain the growth ranges previously agreed upon. For the short run, however, his policy prescription differed from those favored by most of the previous speakers.

In light of the fragile state of the recovery, Mr. Black remarked, he was concerned about the recent slowing in the rate of growth of the monetary aggregates. Because he thought it was important to avoid an overly slow expansion in the aggregates during the late summer and early autumn, he would be prepared to risk a little easing in money market conditions in this inter-meeting period. He agreed that the longer-term outlook pointed to a rise in interest rates, but he thought that over the next few weeks market forces might exert some downward pressure on rates. He would not want to resist such pressures because the result could be slower-than-desired growth in the monetary aggregates over the next few months. For example, he considered it unlikely that M_1 would grow in August at a rate as high as 10-1/2 per cent--as implied under alternative B--given the prevailing level of interest rates.

To put the matter another way, Mr. Black continued, he would favor the specifications of alternative B if he shared the staff's expectations for interest rates and money demands. However, he did not believe that interest rates would move up as soon, or that the demand for money would be as strong, as anticipated by the staff. Although the staff was more skilled than he in making projections, he had some basis for his view. In his judgment, weakness in the inventory situation was likely to persist for some time. That fact, together with continued inventory liquidation abroad--which would tend to reduce foreign borrowing and to stimulate some foreign lending here--would help to stave off a rise in U.S interest rates. Moreover, the demand for money balances would tend to decrease because confidence had been rebounding and because corporations had been financing heavily in the long-term market to fund short-term debt. The only factor likely to exert upward pressure on short-term rates in the period immediately ahead was Treasury financing activity.

With those considerations in mind, Mr. Black said, he would allow some leeway for a reduction in the funds rate during the inter-meeting period by setting the lower limit at about 5-1/4 per cent--a little below the lower limit of alternative B. He would favor an upper limit of 6-1/4 per cent, on the understanding that the funds rate would not be moved above 6 per cent unless there was solid evidence that the July-August rates of growth in the monetary aggregates were running above those specified under alternative B.

The Chairman noted that some members had commented on numerical specifications in expressing their views on policy. He would suggest that that be continued; he would provide an opportunity for those who had not expressed numerical preferences to do so later.

Mr. Bucher said he would have preferred to see the Federal funds rate at a lower level over the past month. As he had indicated at the June meeting, he thought the decision then to permit a rise in the funds rate was somewhat premature. He continued to feel that care should be taken to avoid reacting too quickly to shorter-term movements in the aggregates. Moreover, he shared the concern expressed by Messrs. Coldwell and Mayo regarding the current high level of long-term interest rates relative to levels prevailing at comparable points in previous recovery periods.

Mr. Bucher observed that his policy prescription was similar to Mr. Black's. Like the latter, he questioned whether money demands would be as strong as projected, and he would not be unduly concerned if short-term interest rates declined as a result of market forces. If his reservations about the projected strength of money demands were not warranted, however, he could readily accept the specifications of alternative B.

Mr. Balles said he found encouraging the increasing signs that the recession was bottoming out and that a recovery--however slow--was beginning. On the other hand, the continuance of an inflation premium in long-term interest rates--with mortgage and corporate bond rates currently in excess of 9 per cent--was disturbing. Although that high a level of long-term interest rates was an unfavorable base on which to build a recovery, he was convinced that any efforts to bring those rates down through a more expansionary monetary policy would be counter-productive. In his judgment, such a course would reignite inflationary expectations that, in turn, would quickly be reflected in the level of long-term interest rates. That judgment, and his previously stated preference for a slow rather than a fast recovery, led him to favor a continuation of the recent course of policy--a course rather well described by the specifications of alternative B.

Mr. Eastburn said he thought Mr. Axilrod had put into focus the main issue facing the Committee today--namely, how to move from the recent front-end loading of the aggregates onto a growth path consistent with the Committee's longer-run objectives. To help resolve that issue, staff at his Bank had examined two alternative patterns of change in the Federal funds rate designed to achieve the targets for the aggregates over the year ending June 1976. The results were quite striking.

The first pattern called for maintaining money market rates at current levels through the end of 1975, Mr. Eastburn observed. It turned out that, in order to achieve the desired growth in the aggregates from June to June, the funds rate would have to increase by about 150 basis points per month during the first half of 1976. Under the second pattern, which called for gradual increases in money market rates throughout the year, it was found that an average monthly increase in the Federal funds rate of about 40 basis points would produce the desired results for the aggregates. At the end of the period, the over-all level of interest rates would be substantially higher under the first strategy than under the second.

Any such findings were, of course, highly approximate, Mr. Eastburn remarked. Nevertheless, they offered some insight into the tradeoffs that were involved. As one who had earlier favored front-end loading in the aggregates, he had come to the view that it was now time to move away from that approach and to permit some gradual increases in short-term interest rates. The specifications of alternative B fit his policy prescription. He would be prepared to use the full range for the Federal funds rate shown under that alternative, permitting the rate to rise to the 6-1/2 per cent upper limit over the next 4 weeks, if necessary.

Mr. Kimbrel remarked that he continued to be troubled by the inflationary expectations that appeared to be building up in the economy. Such expectations had been reinforced by the efforts of firms in the aluminum and other industries to raise prices at a time when there was no excess demand and when they were operating at less than full capacity. Inflationary expectations had also been reinforced by discussions of possible grain sales to the Soviet Union and by estimates indicating that supplies of natural gas and electric power were not overly abundant even in the current recessionary environment. And inflationary fears certainly had not been allayed by the recent spurt in money supply growth, even though growth in the monetary aggregates now appeared to be slowing.

Although he did not deny that the unemployment rate remained undesirably high, Mr. Kimbrel said, he continued to feel that the policy stance adopted at the last Committee meeting had been appropriate. He had been pleased by the smooth adjustment to a higher Federal funds rate, and while opportunities for further increases in the funds rate might be limited in the coming period by Treasury financing activity, he would not want to see the rate slip below 6 per cent unless growth in the monetary aggregates fell substantially below current projections. His preference was for a Federal funds rate range of 5-3/4 to 6-3/4 per cent, and he would be prepared to see the rate move to the upper limit if necessary.

Mr. Coldwell observed that the expectation of high rates of growth in the monetary aggregates--which had formed the basis for a shift to a somewhat tighter policy stance last month--had been borne out. In his judgment, however, the available data supported the view that Treasury disbursements of income tax rebates and supplemental social security benefits had caused the bulge in the money supply. He had dissented from the policy decision at the last meeting because he believed then, as he did now, that the Committee should not react to temporary fluctations in the money supply produced by such one-time events, just as it had not reacted to the temporary decline in January.

Mr. Coldwell said he still held to the view that the Committee tended to set too narrow a range for the Federal funds rate and that that, in turn, resulted in excessive activity by the Desk. He continued to favor at least a 3 percentage-point spread in that range. Nevertheless, he had been inclined to resist increases in the funds rate recently because, as he had indicated earlier, he was concerned about entering the recovery with a high level of interest rates; further substantial increases in short-term rates could cause early disintermediation from the thrift institutions and thus abort the recovery. For the period immediately ahead, he favored short-run targets for M_1 and the Federal funds rate that encompassed the entire range from the lower limit of alternative C to the upper limit of alternative A--that is, a 3 to 6 per cent range for growth in M_1 over the July-August period and a 5 to 7-1/4 per cent range for the funds rate.

Mr. Coldwell then observed that he favored the shift to formulating the longer-term aggregate targets on a quarterly average basis. He regretted that that procedure had not been followed originally; its adoption now might be interpreted as a reaction to the rapid growth in the aggregates in June. That was because the application of particular numerical growth ranges to the period between the second quarters of 1975 and 1976 implied lower levels at the end of the period than would the application of the same ranges to the June-to-June period.

Finally, Mr. Coldwell remarked, he would suggest two changes in the wording of the staff's draft of the directive, although he did not feel strongly about them. In the first sentence, he would prefer to say that real output of goods and services had "stopped declining" rather than "leveled off."

Mr. Partee noted that a small decline in real output in the second quarter appeared possible, particularly in light of recent data on inventories. The words "stopped declining" would seem to rule out such a decline, whereas the words "leveled off," while conveying the same general sense, would allow some leeway for a possible decline.

After further discussion, it was decided to retain the words "leveled off."

Mr. Coldwell then observed that, in view of the strengthening in the country's trade position in the past few months, the language of the fourth paragraph indicating that the Committee sought financial conditions "conducive to...working toward equilibrium in the country's balance of payments" might be changed to something like "strengthening the country's balance of payments."

Mr. Solomon said he would hesitate to substitute that particular wording because from the point of view of the rest of the world the U.S. balance of payments was already too strong. He agreed that the phrase "moving toward equilibrium" could be questioned at this time, but at the moment he could not think of a better one.

The Chairman suggested that the language of the draft be retained unless the staff could propose some better alternative later in the meeting.

Mr. Holland observed that he was reasonably satisfied with the way the recovery seemed to be developing and also with the current posture of monetary policy. Some front-end loading in the aggregates had, in effect, been brought about by operations of the Treasury and by developments in the economy and he was pleased that overt monetary policy actions had not been needed to achieve it. He viewed the second-quarter bulge in the money supply as dollars provided to the economy that would not have to be provided later. It was implicit in that view that some slowdown in the rate of growth in the aggregates would be necessary later.

Mr. Holland said he had been impressed by the difficulties the staff had experienced in projecting the size of the bulge in the monetary aggregates associated with the tax rebates and special social security payments, and he suspected that it would be just as difficult to project accurately the pattern in which the bulge would be unwound. He would deal with that problem by adopting 2-month ranges for the aggregates encompassing the entire span from the lower limits of alternative C to the upper limits of alternative A, as Mr. Coldwell had suggested. While even those ranges might not be wide enough, they would at least represent an acknowledgement that in the period ahead the talents of the staff projectors--great though they were--might be inadequate to their task.

Against that background, Mr. Holland continued, and in view of the rather demanding Treasury financing ahead, he would maintain reserve and money market conditions at about their current levels, in the expectation that the Committee would reassess the situation at the next meeting when new data on the behavior of the aggregates would be available. Accordingly, he would hold the Federal funds rate in a daily operating range of 5-3/4 to 6 per cent unless the aggregates were tending to exceed the limits of their specified ranges. Even if the aggregates were above the tops of their ranges, he would broaden the funds rate range only a little--to, say, 5-1/2 to 6-1/4 per cent.

In sum, Mr. Holland remarked, he would maintain the current money market climate for a while longer. He was not ready to move toward a tighter policy now on the basis of projections of excesses next year because he was not yet persuaded that prices, interest rates, and the narrow money supply would rise as much as indicated by the staff's projections. He could, of course, be wrong in that judgment; developments in the weeks ahead would provide some insights into the future course of events. While he recognized that lags in the impact of monetary policy necessitated action well in advance of the desired results, such considerations led him to favor a policy of no change in reserves and money market conditions over the coming inter-meeting period.

For the language of the operational paragraph of the directive, Mr. Holland continued, he could accept alternative B, but he would change the last clause to read as follows: "provided that growth in monetary aggregates slows substantially from the recent bulge."

Chairman Burns commented that he found the language of both alternatives A and B rather ambiguous. However, the Committee could discuss the directive further later in the meeting. At this point it would be helpful to have Mr. Partee's advice to the Committee.

Mr. Partee said there were two major points that the Committee might want to take into consideration in selecting its short-run operating targets. First, he would underscore the comments made by Mr. Axilrod and several members of the Committee regarding the projected near-term pattern of change in nominal GNP. The rate of growth in nominal GNP was expected to rise from 1-1/2 per cent in the first half of 1975 to over 13 per cent in the second half--an unusually large increase. While some change in the demand-for-money function could accompany an increase of that magnitude in nominal GNP, there was likely to be more strength in the monetary aggregates from this point on than could be easily accommodated under the Committee's longer-term growth rates.

Accordingly, Mr. Partee observed, he felt rather strongly that short-term interest rates would be moving upward--if perhaps irregularly--over the months ahead. Accordingly, any significant decline in the Federal funds rate during the coming period would give a false signal to the market, and together with the subsequent rise, it would amount to whiplashing. Moreover, a temporary easing could lead to unwanted speculation in short-term securities. That would be particularly hurtful now, just before a sizable Treasury financing; the warm reception the financing would receive would be the prelude to a subsequent sharp reaction. Thus, in the absence of indications that the recovery was falling short of expectations and that the anticipated strengthening in the demand for money was not developing, he would be inclined not to seek a decline in interest rates. Some little downward leeway for the Federal funds rate would not be troublesome, but in his judgment a substantial leeway would represent questionable policy at this time.

His second point, Mr. Partee continued, had to do with the short-run target ranges for the monetary aggregates. During the May-June period M_1 had increased at an annual rate of 14-1/2 per cent--well above both the Committee's desires and the staff's projections. Targets for the July-August period had to be viewed in the context of that experience, 2 months of growth at a rate of, say, 3 per cent was not slow when it followed 2 months of 14-1/2 per cent growth. The Committee should also keep in mind that, just as the staff had not been able to foresee the strength in the money supply in May and June, it might be underestimating the magnitude of the slowing in July and August; there was some risk that money supply growth would be a good deal smaller than now projected. He would suggest that the Committee consider reducing the lower limits of the 2-month ranges for the monetary aggregates to provide for that possibility. In his judgment, a range of about 2-1/2 to 5-1/2 per cent for M_1, with corresponding adjustments in the ranges for the other aggregates, and a Federal funds rate range of about 5-1/2 to 6-3/4 per cent would be appropriate.

The Chairman then invited those speakers who had outlined their views on the broad direction of monetary policy without reference to numerical specifications to briefly state their preferences now.

Mr. Debs observed that he favored ranges of 2-1/2 to 5-1/2 per cent for M_1 and 7 to 10 per cent for M_2, for the reasons Mr. Partee had outlined. He might note in that regard that the New York Bank projections for growth in the monetary aggregates in the July-August period were about 1 percentage point lower than those of the Board staff. For the Federal funds rate, he favored a range of 5-3/4 to 6-3/4 per cent. He would also state his preference for 6-month growth rates of 7 per cent for M_1 and 9-1/2 per cent for M_2, although he realized that rates for 6-month periods were no longer included among the Committee's specifications. Finally, for the language of the directive he preferred the "substitute" wording, calling for "moderate growth in monetary aggregates over the months ahead."

Mr. Mayo said he favored ranges of 5-1/2 to 6-1/2 per cent for the Federal funds rate, 2-1/2 to 5-1/2 per cent for the 2-month growth rate in M_1, and a corresponding range for M_2. He found the language of alternative B acceptable and he preferred it to the substitute wording.

Mr. Wallich commented that he preferred a somewhat wider range for the Federal funds rate--5-1/2 to 7 per cent. For M_1, he favored a range of 3 to 5-1/2 per cent.

Mr. Leonard observed that he favored ranges of 5-1/2 to 7 per cent for the funds rate and 2-1/2 to 5 per cent for M_1.

Mr. Morris remarked that he had been prepared to accept the specifications given under alternative B but he would not object to the lower limit of 2-1/2 per cent for M_1--with corresponding adjustments for the other aggregates--as suggested by Mr. Partee.

Chairman Burns then suggested that the Committee resolve the question of the language of the operational paragraph of the directive. The statement in alternative B that "the Committee seeks to maintain about the prevailing bank reserve and money market conditions over the period immediately ahead" seemed to capture the

Committee's consensus. However, he found troublesome the following clause, which read "in the expectation that growth in monetary aggregates will slow substantially." In his judgment, the lack of a time reference in that clause rendered it virtually meaningless.

In the discussion that followed, it was suggested that the term "slow substantially" most appropriately characterized a slowing in the rate of growth of the monetary aggregates in July and August from the rapid rates recorded in the second quarter. From the discussion a consensus emerged in favor of the following language: "...the Committee seeks to maintain about the prevailing bank reserve and money market conditions over the period immediately ahead, provided that growth in monetary aggregates appears to be slowing substantially from the bulge during the second quarter."

The Chairman then observed that he was in broad sympathy with the sentiment of the majority of the Committee, but given the lateness of the hour he would not discuss his reasons. For the numerical specifications, he thought the following ranges reflected the thinking of the majority: 2-1/2 to 5-1/2 per cent for M_1, 8 to 10-1/2 per cent for M_2, and 5-1/2 to 6-3/4 per cent for the Federal funds rate.

Mr. Coldwell said he could not accept a 2-1/2 per cent lower limit for the July-August M_1 range. He would be concerned that, with such a lower limit, a rate of growth in M_1 as low as 3 per cent would result in no attempt to lower the Federal funds rate.

Chairman Burns remarked that, if the monetary aggregates appeared to be growing at rates near the lower ends of their ranges, the Desk would be expected to seek a Federal funds rate near the lower end of its range. Thus, under the circumstances mentioned by Mr. Coldwell some reduction in the funds rate would be sought. The consequence of setting the lower limit for the M_1 range at 2-1/2 per cent, rather than at some higher level, would be that the funds rate would be reduced more slowly.

The Chairman then asked the Committee members to indicate informally whether they preferred a lower limit for M_1 of 2-1/2 or 3-1/2 per cent.

A majority of the members expressed a preference for 2-1/2 per cent.

In response to a question from the Chairman, Mr. Coldwell said he would still object to a limit as low as 2-1/2 per cent, because it would tend to result in a higher Federal funds rate than otherwise would be the case.

Mr. Bucher remarked that he shared Mr. Coldwell's feelings on that point.

Chairman Burns suggested that perhaps a compromise could be reached by adopting a lower limit of 3 per cent for M_1.

There was general agreement with the Chairman's suggestion.

Chairman Burns then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and the language for the operational paragraph the Committee had agreed upon earlier. It would be understood that the directive would be interpreted in accordance with the following specifications. The ranges of tolerance for growth rates in the July-August period would be 3 to 5-1/2 per cent for M_1, 8 to 10-1/2 per cent for M_2, and a range for RPD's consistent with the foregoing, as determined by the staff. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 5-1/2 to 6-3/4 per cent.

> With Mr. Holland 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 leveled off in the second quarter of the year, as consumer spending continued to strengthen. Activity in residential real estate markets has picked up in recent months. In June industrial production rose slightly, following 8 months of decline. The calculated unemployment rate declined substantially, but this was attributed mainly to problems of seasonal adjustment. Average wholesale prices of industrial commodities rose somewhat more in June than in the preceding 3 months, chiefly because of increases in prices of petroleum products, but prices of farm and food products declined appreciably. From the first to the second quarter of the year, the advance in average wage rates continued to moderate.

In recent weeks the average exchange value of the dollar against leading foreign currencies has risen considerably, as interest rates on U.S. dollar assets increased relative to rates on foreign currency assets after mid-June. In May the U.S. foreign trade balance registered a substantial surplus, as imports dropped more sharply than exports. U.S. banks reported a sizable increase in claims on foreigners, while liabilities to foreigners were reduced slightly.

Growth in M_1, M_2, and M_3--which was substantial in May--was extremely rapid in June, in part because of Federal income tax rebates and of supplementary social security payments; beginning late in the month, after completion of such payments, the aggregates weakened. Business demands for short-term credit remained unusually weak both at banks and in the commercial paper market, while demands in the long-term market continued exceptionally strong. Market interest rates in general have risen appreciably in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of the forthcoming Treasury financing and of developments in domestic and international financial markets, the Committee seeks to maintain about the prevailing bank reserve and money market conditions over the period immediately ahead, provided that growth in monetary aggregates appears to be slowing substantially from the bulge during the second quarter.

Secretary's note: Following the meeting, Mr. Holland advised the Secretary that he had dissented from this action because he believed that present circumstances did not warrant providing for a possible rise in the Federal funds rate to a level as high as 6-3/4 per cent in the period until the next meeting. He preferred to maintain bank reserve and money market conditions in the inter-meeting period closer to those now prevailing, in the expectation that by the next meeting the unwinding of the recent bulge in monetary aggregates caused by unusual Treasury payments would have proceeded far enough to permit monetary policy decisions to be related more closely to underlying trends in the aggregates.

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

It was agreed that the next meeting of the Committee would be held on Tuesday, August 19, 1975.

Thereupon the meeting adjourned.

Arthur L. Broida

Secretary

ATTACHMENT A

Henry C. Wallich
July 29, 1975

Notes on Meeting of Bank for International Settlements
Basle - July 7, 1975

At the Governors' meeting, the tone of the discussion of the economic outlook was more subdued than on past occasions. None of the other central banks believed that their respective economies were in a clear upturn as yet, and several -- including particularly the Germans and Japanese -- expressed disappointment over their latest indicators. The disappointment was general over the sluggishness of the German economy. Most expressed some hope for recovery later in the year, especially now that the U.S. picture is brightening, but the French and Canadians do not expect the upturn until next spring and the British are in no position to forecast a turnaround at all. The Bank of England expressed cautious optimism over the latest efforts to restrain wages in the United Kingdom, with more decisions forthcoming, but asked for forbearance of the others as major wage contracts are still to be negotiated beginning in September.

As can be expected, other members of the group warmly welcomed the improvement in the U.S. economy and questioned us closely on the outlook for interest rates here. Several also expressed satisfaction over the recent rise of the dollar in the exchange markets. The Germans and Swiss went so far as to indicate that they were hoping for a stimulus to their exports as a result. I argued that the others should not rely too much on foreign demand to stimulate their economies and that, in view of the lags involved, they could hardly expect a decline in their exchange rates to boost their exports this year.

In a separate meeting, the possibility of a contribution by the BIS to the IMF oil facility was discussed. The proposal was for a contribution of perhaps SDR 500 million, to be financed by deposits with the BIS denominated in SDR, by such central banks among the BIS group as might wish to participate. It was recognized that special arrangements would have to be made to provide liquidity to the BIS if a contributing central bank should have to withdraw its funds. These arrangements, it was understood, would involve a substantial interest penalty. Only two of the participating central banks expressed an interest in making contributions. Both objected to doing so in SDR, indicating they would prefer dollars. The terms offered in case of premature withdrawal were criticized as unattractive. Some governors said that it was a mistake for the BIS to get into this kind of operation. I noted that the U.S. Executive Director had not taken a formal position on the proposal in the IMF, but had raised certain questions. My impression is that this matter is likely to be dropped.

ATTACHMENT B

July 14, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on July 15, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services leveled off in the second quarter of the year, as consumer spending continued to strengthen. Activity in residential real estate markets has picked up in recent months. In June industrial production rose slightly, following 8 months of decline. The calculated unemployment rate declined substantially, but this was attributed mainly to problems of seasonal adjustment. Average wholesale prices of industrial commoties rose somewhat more in June than in the preced 3 months, chiefly because of increases in prices of petroleum products, but prices of farm and food products declined appreciably. From the first to the second quarter of the year, the advance in average wage rates continued to moderate.

In recent weeks the average exchange value of the dollar against leading foreign currencies has risen considerably, as interest rates on U.S. dollar assets increased relative to rates on foreign currency assets after mid-June. In May the U.S. foreign trade balance registered a substantial surplus, as imports dropped more sharply than exports. U.S. banks reported a sizable increase in claims on foreigners, while liabilities to foreigners were reduced slightly.

Growth in M_1, M_2, and M_3--which was substantial in May--was extremely rapid in June, in part because of Federal income tax rebates and of supplementary social security payments; beginning late in the month, after completion of such payments, the aggregates weakened. Business demands for short-term credit remained unusually weak both at banks and in the commercial paper market, while demands in the long-term market continued exceptionally strong. Market interest rates in general have risen appreciably in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of the forthcoming Treasury financing and of developments in domestic and international financial markets, the Committee seeks to achieve somewhat easier bank reserve and money market conditions over the period immediately ahead, provided that growth in monetary aggregates appears to be slowing substantially.

Alternative B

To implement this policy, while taking account of the forthcoming Treasury financing and of developments in domestic and international financial markets, the Committee seeks to maintain about the prevailing bank reserve and money market conditions over the period immediately ahead, in the expectation that growth in monetary aggregates will slow substantially.

Alternative C

To implement this policy, while taking account of the forthcoming Treasury financing and of developments in domestic and international financial markets, the Committee seeks to achieve somewhat tighter bank reserve and money market conditions over the period immediately ahead, in order to encourage a substantial slowing of growth in monetary aggregates.

Possible substitute wording for all alternatives

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

ATTACHMENT C

July 15, 1975

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

5. Other considerations: account to be taken of the forthcoming Treasury financing and of developments in domestic and international financial market

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.