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

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

Messrs. Balles, Black, Francis, 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. Bernard, Assistant 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, Davis, Green, Kareken, Reynolds, and Scheld, Associate Economists

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

Mr. Coyne, Assistant to the Board of Governors
Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Adviser, Division of International Finance, Board of Governors
Mrs. Farar, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Eisenmenger and Doll, Senior Vice Presidents, Federal Reserve Banks of Boston and Kansas City, respectively
Messrs. Hocter, Snellings, Brandt, and Balbach, Vice Presidents, Federal Reserve Banks of Cleveland, Richmond, Atlanta, and St. Louis, respectively
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on August 19, 1975, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on July 15, 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

August 19 through September 10, 1975, and a supplemental report covering the period September 11 through 15, 1975. Copies of these reports have been placed in the files of the Committee.

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

> Since the last meeting the dollar has remained caught up in several crosscurrents. It has been buoyed by expectations of different rates of economic recovery here and abroad, as further evidence of a pick-up of activity in the United States has contrasted with the continuing sluggishness of most other industrial economies. In this context interest rate expectations have also favored the dollar, as most money market rates here have firmed while interest rates abroad have continued to decline. Lately, the easing of market interest rates elsewhere has been only modest, but official discount rates have been cut in several countries and these actions have reinforced the view in the market that interest rates abroad may well fall further.
>
> At the same time concern over the price outlook here has weighed on the dollar in the exchanges. A common scenario in the minds of traders is that once both the United States and Europe are clearly on the path of recovery, the United States will emerge with a higher rate of inflation than many of our key trading partners. I think this is unlikely, but it is a view that currently influences many exchange market decisions. New York City's difficulties also gave pause to the exchanges for a while, not because foreigners hold much New York City paper in their portfolios but because of the market's concern over the implications of a potential default for the New York banks and for the U.S. financial markets more generally. Recent steps to meet the City's immediate financial needs have eased those concerns for the time being. Dollar rates fluctuated in a 1 to 1-1/2 per cent range over most of the period, but they have begun to rise over the last few days and are now above early-August highs. Today, there was

a positive reaction to the latest increase in the U.S. production index and the dollar broke through the 2.60 benchmark against the German mark.

In our operations we have continued our very modest program of acquiring mark balances for future contingencies and currently we hold some $30 million equivalent. We entered the market as a seller of currencies on only one occasion during the period, offering marks when the dollar dropped abruptly after our $1 billion trade surplus was announced on August 26, but our offer was not taken up. Other major central banks, however, have continued to intervene in size, with a total of $2.4 billion of intervention on both sides of the dollar market since the last meeting.

Looking ahead, I remain persuaded that the United States still has considerable unrealized competitive strength in world markets, which should not only sustain a strong trade balance but also buttress the dollar over the months ahead. Much depends on the relative pace of recovery in the United States and abroad, however. To a degree the dollar is currently benefiting from the market's probably excessive bearishness toward the outlook for economic activity--and for interest rates--in Europe. Clear signs of recovery elsewhere, while eventually helping our trade balance, could lead to a sharp reversal of these bearish expectations, leading to downward pressure on the dollar. These pressures could quickly cumulate, particularly now that some of the money markets, especially in Germany, are more open to inflows of short-term funds.

Finally, as agreed last time, the swap line with the Bank of Mexico was doubled on August 29. The Mexicans have come forth with a stabilization program, which should help, but as expected they did have a substantial reserve loss late in August and early in September. Selling pressure has recently tapered off. The Mexican authorities have not requested a drawing on the swap line as yet, but on the basis of the Committee's discussion last month we stand prepared to agree to a drawing in full if they should need it.

Chairman Burns asked Mr. Pardee to elaborate on the reasons for his confidence in the competitive strength of the dollar in the foreign exchange market.

Mr. Pardee responded that he was more confident about the outlook for the dollar than many market participants and other observers in part because of the price level differentials between the United States and such continental European countries as Germany, France, and Switzerland. Also, the recent pick-up in the U.S. rate of inflation was related in large measure to increases in food and fuel prices. Because other countries were being affected by the same price pressures, he disagreed with the view that inflation would be more severe in the United States than in other countries.

Mr. Pardee recalled that earlier in the year he had referred to the dollar as being unrealistically low in relation to the currencies of major European countries. In light of the dollar's appreciation he would no longer use the word "unrealistic," but he still thought the dollar was relatively low.

> By unanimous vote, the System open market transactions in foreign currencies during the period August 19 through September 15, 1975, were approved, ratified, and confirmed.

Chairman Burns then asked whether Mr. Holmes had any recommendations to make to the Committee.

Mr. Holmes indicated that two swap drawings on the Belgian National Bank, totaling $31.8 million, would mature for the seventeenth time on October 17 and 24. He regretted having to recommend their renewal. As he had reported at the previous meeting, Mr. Wallich and he had hoped to meet with Treasury officials in an effort to work out some sort of compromise on the issue of loss-sharing with the Bank of Belgium. Unfortunately, the meeting had had to be postponed because of the press of other Treasury business, but he hoped it would be held soon.

If the Treasury was willing to compromise on the loss-sharing issue, Mr. Holmes continued, he would recommend that a final effort be made to reach an agreement with the Belgians at the time of the next meeting of central bank governors in Basle. If that effort should fail, and he had no grounds for being optimistic, he would plan to recommend a definite course of action to the Committee. In his view the negotiations relating to this matter had already been unduly protracted.

Mr. Holmes added that Mr. Wallich and he had met with the Belgian authorities during the recent Bank-Fund meetings in Washington. He had the impression that the Belgians had retreated from their previous position. They no longer seemed as ready as they had earlier to go forward with the legal steps necessary to implement the revaluation clause of the old swap contracts, and they did not appear to want the System to repay its drawings. Perhaps their change of attitude was related in part to the impasse on the loss-sharing issue. In any event, he thought one last effort should be made to reach a solution. The course of action he would recommend if the effort failed might well give rise to friction with both the U.S. Treasury and the Belgians.

In response to questions, Mr. Holmes indicated that the System had refrained from buying Belgian francs in the market in accordance with a specific Treasury request. It might have been possible to purchase a modest amount of francs over the course of recent weeks--perhaps $15 to $20 million equivalent--without causing a significant market reaction.

Mr. Holland observed that purchases of $20 million francs would have amounted to nearly 10 per cent of the outstanding debt on the Belgian swap line.

Mr. Wallich said he thought the Belgians did not want the System to repay the drawings primarily because, as long as the drawings were outstanding, the National Bank of Belgium was provided with cover for an equivalent amount of dollars. He noted that if the dollar should appreciate some 4 per cent further against the Belgian franc, there would no longer be a loss on the swap drawings related to exchange rate fluctuations and the disagreements over loss-sharing would disappear. Such an appreciation would provide a logical opportunity to repay the drawings. It would be unfortunate if the System did not take advantage of that opportunity because it might not last.

In any case, Mr. Wallich continued, he agreed with Mr. Holmes that an effort should be made to reach an agreement with the Belgians. He suspected that the Bank of Belgium would not want to sell francs directly to the System. The question then would be how rapidly the System might be able to acquire francs in the market without seeming to the Belgian authorities to be uncooperative.

Mr. Volcker said he did not share the feeling of urgency about repaying the drawings. The drawings had been made some four years ago, and he did not understand why it was now necessary to repay them quickly, if the cost would be to create friction with both the Treasury and the Belgians.

Mr. Wallich observed that an earlier opportunity to repay the drawings without a market loss had been missed. He favored moving promptly to take advantage of any similar opportunities that presented themselves.

Mr. Volcker remarked that he too would want to seize any such opportunities.

Chairman Burns said he thought many members of the Committee--possibly a majority--shared the view that the drawings should be repaid as promptly as feasible. He believed that any unhappiness on the part of the Treasury officials would be temporary.

Mr. Holland said he felt strongly that a procedure was needed for retiring the System's long-outstanding drawings as promptly as feasible because it was important for the System to validate the principle that the swap lines were a mechanism for short-term credits between central banks. Indeed, he had begun to entertain the thought of voting against further renewals of long-outstanding drawings unless he believed that the System was doing everything in its power to repay such debts promptly.

> By unanimous vote, renewal for further periods of 3 months of System drawings on the National Bank of Belgium, maturing on October 17 and 24, 1975, was authorized.

Mr. Holmes observed that, as Mr. Pardee had noted, the Desk had purchased a small amount of foreign currencies in the period since the previous meeting. He thought it would be desirable to continue such acquisitions on a modest scale. If market conditions permitted, he would suggest building up the System's total holdings of foreign currencies to perhaps $100 million equivalent and certainly to no more than $150 million equivalent.

In reply to a question, Mr. Holmes said that while he would plan to purchase a variety of currencies, he suspected that the bulk of the purchases would be of German marks. If an opportunity arose, he would want to make a start on buying Belgian francs, even though it might not yet be possible to use the francs to pay down the swap debt.

Mr. Holland said he favored a modest accumulation of foreign currencies, and he thought it would be desirable to have an understanding about the total amount to be acquired. He wondered whether there might be an opportunity to use third currencies to reduce the Belgian drawings; perhaps those drawings could be repaid more quickly if several currencies were employed.

Mr. Holmes indicated that the Desk would be exploring that possibility. The potential use of third currencies would depend, of course, on the position of the Belgian franc within the snake.

Mr. Pardee said that one repayment alternative already explored with the Belgians was the possible use of proceeds from U.S. sales of airplanes to Belgium.

In reply to a question, Mr. Pardee noted that the Committee's foreign currency authorization set a limit of $250 million on System holdings of uncovered foreign currencies.

Chairman Burns suggested that the Desk not acquire more than $100 million equivalent of foreign currencies without consulting further with the Committee.

There was no objection to that suggestion.

Secretary's note: A copy of a report by Mr. Solomon on the September 5 meeting of Working Party 3, which was distributed to the Committee on September 11, is 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. Gramley made the following statement:

> A month ago the staff reported to the Committee that economic developments in the second quarter had, in our judgment, set the stage for a fairly sharp snapback in production and employment during the second half. Data becoming available over the past month appear to confirm that view; business activity is improving on a broad and widening front.
>
> The employment data for August that became available 10 days ago evidenced a substantial degree of strength developing in labor markets over recent months. True, the unemployment rate held steady at 8.4 per cent in August, but nonfarm payroll employment increased by half a million, including a 200,000 rise in manufacturing. The factory workweek also lengthened further and now stands a full hour above the March trough. The percentage of industries adding to their payrolls in August jumped sharply, to 72 per cent, the highest proportion since November 1973. Furthermore, estimates of nonfarm payroll employment for earlier months were revised up significantly.
>
> The statistics on industrial production released yesterday also tell a story of a cyclical process gathering momentum. Production estimates for May through July were revised up. The trough in industrial output is pushed back to April, and the revised index now shows a gain of 1.5 per cent from April through July. A further increase of 1.3 per cent occurred in August, and gains were quite widespread. Significantly, durable materials were up for the first time since last October, and output of business equipment showed its first advance in 11 months. Judging by the trend of new orders for durables, a further rise in durable goods production seems likely in the months ahead. I would caution the

Committee, also, that our estimate of the August rise in industrial production assumes that the increase in manhours worked in manufacturing, as reported by BLS, was overstated because of seasonal adjustment problems. If this interpretation is wrong, output could have increased more last month than the estimated rise of 1.3 per cent.

The upswing in industrial activity now under way seems to stem principally from a reduction in the pace of inventory liquidation. Book-value inventory figures for July--which include a sizable accumulation at retail stores--show an over-all rate of liquidation close to that of June and well below the second-quarter average. However, final sales in the third quarter appear to be holding up quite well. There was some slippage in retail sales during August, but that is hardly surprising following 4 months of sizable increases.

On the price side, the news of the past month has hardly been comforting, but the situation appears no worse than a month ago. The index of industrial commodity prices at wholesale rose somewhat faster in August, but this was due mainly to increases in energy prices that actually took place in July; the farm and food component declined a little in August, and prices of some farm products have eased further since the August pricing date. Wage rate increases in August were large, but month-to-month variations in the index of average hourly earnings are quite volatile, and there are no clear signs yet that the pace of wage advance has broken out of the relatively moderate pattern of recent months.

The developments of the past month have been broadly in line with earlier staff expectations, and so we were not led to change materially our projections of economic activity and prices from the previous green book.[1/] We still believe real GNP growth will average around 8 per cent, annual rate, over the second half of this year, sparked by a reduction in the pace of inventory liquidation. Such a rebound will, we believe, lead to a significant strengthening in business capital expenditures beginning later this year and continuing well into 1976.

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

We also hold to the view, however, that the forces of expansion will be weakening over the course of next year, so that real growth is projected to diminish to around a 4-1/2 per cent annual rate by the second half of 1976. The expected weakening is predicated on the same general considerations as we outlined a month ago--such as the declining degree of stimulation expected from the inventory sector as the recovery proceeds; a relatively weak rebound in housing; State and local expenditures constrained by the pronounced weakness in the market for municipal securities; public utility spending held back by the widespread cancellations of planned capital spending programs that began in early 1974 and continued until recently; and the increasing tightness in financial markets that seems likely to develop over the next couple of quarters--if our assumptions about prices and monetary policy are broadly correct.

Our current GNP projection assumes, as the last one did, that the price of old oil is decontrolled abruptly, that the $2 import fee is removed, and that the OPEC price of crude is increased by $1 at the beginning of next month. Given the events of recent days, these energy assumptions no longer seem like the most probable outcome. We have held to them only because what will happen in this area is still unclear, and we wanted to avoid potentially confusing changes in our projection numbers.

For similar reasons, we have stayed this time with the assumption that monetary policy would permit the growth rate of M_1 to drift up, beginning in the fourth quarter, toward the higher end of the 5 to 7-1/2 per cent range--specifically to a 7-1/4 per cent rate. Such a growth rate of narrow money would be accompanied, we believe, by annual rates of increase in M_2 and M_3 near the lower ends of their target ranges. Thus, the projected increases over the year ending in the second quarter of 1976 consistent with a 7-1/4 per cent increase in M_1 are around 9 per cent for M_2 and about 10 per cent for M_3--in each instance, about 1 percentage point below the midpoints of the ranges earlier adopted by the Committee.

Last month, interest was expressed by a number of Committee members in the probable effects of holding to a 6-1/4 per cent growth target for M_1. A special table has been distributed dealing with that question.[1/] The data presented depend heavily on simulations done on the Board's econometric model, though we have made some judgmental adjustments in the model's output.

1/ The table is appended to this memorandum as Attachment B.

Given the staff's expectations about economic activity and prices, holding to a 6-1/4 per cent target rate for M_1 would, we believe, give rise to additional strains in financial markets, particularly over the first half of next year. Thus, we would expect the commercial paper rate to rise above 12 per cent by the second quarter before beginning to turn down. The added financial restraint would, we think, be sufficient to slow the growth of real GNP materially--to an annual rate of around 3 per cent by the fourth quarter of next year. As a result, the unemployment rate--instead of continuing to decline throughout 1976, as in the green book projection--would level out at about 7-3/4 per cent around midyear 1976 and then begin to inch up late in the year. Price performance would be expected to improve somewhat, however, with the annual rate of increase in the fixed-weighted deflator for gross private product .2 or .3 percentage points less than in our green book projection by late next year.

The outcome of this exercise does not suggest that maintaining a 6-1/4 per cent monetary growth rate--in the face of the assumed price increases--would bring on a recession next year. It does suggest that the effects on real economic activity would be extensive. Housing starts would be a good deal weaker, and business fixed investment and personal consumption expenditures would also be affected adversely. Moreover, inventory-sales ratios would be moving up rather significantly late next year, increasing the prospects for a further weakening of real expansion thereafter.

In closing, I would call the Committee's attention to several factors that could cause economic and financial developments to take a different course than that projected by the staff. First, a compromise on decontrol of old oil prices may remove part of the bulge in the price level we are now projecting for the next two quarters. Second, signs are developing--though they are not as yet entirely convincing--that Federal expenditures may run somewhat above our current projections. Third, while we have trimmed down our projections of State and local expenditures because of a recent turbulence in municipal securities markets, we have made no explicit allowance for the effects of a New York City default. In the weeks to come, we will be dealing with these considerations as and when we get a better handle on them.

Chairman Burns asked how the industrial production index would be affected if the staff was mistaken in its judgment that the increase in manhours worked in manufacturing reported for August was overstated.

Mr. Gramley replied that if the staff interpretation of the August manhours data proved to be wrong, the September manhours figures probably would continue to show substantial strength. In that event, the August index of industrial production most likely would be revised upward.

Mr. Wallich noted that the assumption of a 6-1/4 per cent rate of growth in M_1, instead of a 7-1/4 per cent rate, resulted in a relatively small reduction in the pace of increase in prices toward the end of the projection period, and he asked whether the staff would expect that an 8-1/4 per cent rate of monetary growth would have a correspondingly small effect in raising the projected rate of increase in prices.

Mr. Gramley replied that he would expect the effects to be correspondingly small in the present circumstances of widespread excess capacity and high unemployment. If resource utilization rates were higher, however, he would not expect the effects to be symmetrical.

Chairman Burns noted that the two rates of monetary growth that had been assumed--6-1/4 and 7-1/4 per cent--resulted in virtually the same projected rates of increase in prices over the next three quarters, and he asked whether a reduction in the assumed rate of monetary expansion to 5-1/4 per cent also would have little effect on the projected pace of increase in prices.

Mr. Gramley said he thought that would be the result. The more restrictive monetary policy first would reduce output and employment and only later would lower the rate of increase in prices.

Mr. Black, referring to a statement in the green book, asked about the possible degree of the upward bias in the total wholesale price index for August because of the seasonal adjustment procedure used by BLS. Concerning the industrial component of the index, he asked how much the August rise had been affected by the delay in incorporating the July increase in gasoline prices until August. In effect, he wished to know whether or not the rise in industrial commodity prices had accelerated in August, as suggested by the published indexes.

In response, Mr. Gramley observed that BLS calculated seasonal adjustment factors for the total wholesale price index that were independent of the factors calculated for the major components. As a result, the seasonally adjusted total sometimes differed significantly from a weighted average of seasonally adjusted indexes for the components. In August the weighted average of the two major subcomponents of the index rose .2 per cent, whereas the published index for the total rose .8 per cent. With respect to the impact of the increase in gasoline prices, the staff did not have a precise estimate; he would guess that it amounted to a few tenths of the .6 per cent rise in the industrial index in August. He would judge that, apart from the increase in gasoline, the rate of rise in industrial prices had changed little between July and August.

Chairman Burns remarked that he had discussed the seasonal adjustment problem with the Commissioner of Labor Statistics, who was concerned about the inconsistencies in the published seasonally adjusted indexes for prices--and also about a similar inconsistency that had appeared in the July statistics for labor force, total employment, and unemployment. As far as the wholesale price index was concerned, however, the Commissioner felt that the published seasonally adjusted total for August came closer to the correct figure than did the weighted average of the seasonally adjusted components.

Mr. Kimbrel asked whether the staff projection of housing starts reflected the weakened condition of the construction industry as well as the anticipated rise in interest rates and resulting disintermediation.

In response, Mr. Gramley commented that the projected recovery in residential construction was rather weak, in part because of a number of problems within the housing industry itself. The overhang of unsold condominium units was still large; failure rates for contractors had been substantial and apparently were continuing high; and construction finance remained difficult to obtain and quite costly.

Mr. Holland noted that for purposes of the projection the staff had assumed the extension of certain stimulative tax measures that now were scheduled to expire at the end of this year. He asked whether the staff had examined alternative monetary policies with the assumption that the tax measures were not extended and, accordingly, that fiscal policy was less stimulative. He was interested specifically in the issue of whether a less stimulative fiscal policy with a more stimulative monetary policy might represent a more optimal mix.

In response, Mr. Gramley said the staff had assumed that the $8.5 billion reduction in tax liabilities on 1975 personal incomes would be extended to 1976 incomes and that the investment tax credit would remain at 10 per cent rather than drop back to 7 per cent. However, those assumptions did not represent a more stimulative fiscal policy, because withholding rates for personal taxes would still have to be increased at the beginning of 1976.

Nevertheless, the odds seemed to favor more rather than less fiscal stimulus, because--as he had noted in his statement--Federal expenditures were running above staff estimates. The expectation was developing that total expenditures for fiscal 1976 would be around \$373 billion, rather than close to the \$367 billion target set in the Congressional budget resolution. Concerning Mr. Holland's question, the staff had not made projections to evaluate different mixes of policy. In his judgment, however, the failure to extend the tax reduction on personal income would bring about an undesirable weakening in personal consumption expenditures.

Chairman Burns asked, with respect to the econometric model, what effect changes in the price level had on the personal saving rate.

Mr. Gramley replied that the model dealt with inflation's effect on the saving rate indirectly, through its effect on the real value of consumers' financial assets. Principally because of the impact of inflation, the model suggested much less expansion in consumption expenditures than did the staff's judgmental projection; a saving rate of 8-3/4 per cent, compared with 8 per cent in the judgmental projection; and a level of real GNP in the fourth quarter of 1976 that was lower by 1-1/2 per cent.

Mr. Winn remarked that retailers in the Cleveland District had been surprised by the strength and breadth of the rise in consumer spending during the summer, and they were concerned now that the strength might not continue. One possible indication of a shift toward hoarding by consumers was a sudden spurt in sales of diamonds in September. He asked whether any of the surveys suggested that consumption expenditures would weaken.

Mr. Gramley replied that the recent surveys of consumer attitudes had not suggested unusual strength in consumer spending. On the other hand, the most recent statistics did not suggest that consumers were about to retrench. For example, sales of domestic-type automobiles rose further in the first 10 days of September to an annual rate of 8-1/2 million--the highest rate in over a year. At the moment, continued improvement in consumer spending appeared likely.

Mr. Winn then commented that the proportion of total housing starts accounted for by multi-family units had declined sharply. He asked what effect removal of the tax shelter for second homes would have on the staff's projection of starts.

Mr. Gramley replied that the current projection suggested only a mild upturn in multi-family starts, and elimination of the shelter probably would lead the staff to revise the level of starts downward somewhat.

Mr. Jackson said he believed that the tax shelter was less of an influence now than it had been in past years, because recapture provisions in the tax code were proving to be quite a discipline.

Removal of the shelter was therefore likely to have less of an adverse impact than it might have had earlier.

Mr. Francis said he believed that recovery in economic activity was under way. However, the staff projection of real growth in the second half of this year was a little above the rate he thought was developing. In any case, he would prefer to see a less rapid and more prolonged recovery in output. With respect to monetary growth, the staff suggested that a rate in excess of 6-1/4 per cent for M_1 was necessary in order to moderate the rise in interest rates over the next three quarters. As he read recent history, however, such a policy course had been followed on three occasions in the past 10 years, and each time the monetary stimulus had intensified inflationary pressures, raising interest rates even higher. And then policy had been reversed and recession in output had followed. In his view it would be better to continue a policy of moderate monetary expansion, allowing interest rates to peak earlier and then start to decline. The effort to moderate the rise in interest rates would lead to another recession later.

Mr. Gramley commented that the recent rise in manhours worked, in combination with an assumption of reasonable growth in productivity, suggested that output would expand at an annual rate of at least 8 per cent in the second half of this year. If the employment and manhours figures for September proved to be strong, confirming the August gains, the expansion in output in the third quarter would be even higher than presently projected. The momentum that was appearing in the labor market suggested that this recovery was developing along lines more or less typical of earlier post-war recoveries. In those recoveries, output had grown at a rate of around 8 per cent for at least a couple of quarters.

Mr. Mayo observed that the staff presentation of an alternative projection based on the assumption of M_1 growth at a 6-1/4 per cent rate enhanced understanding of the basic projection in the green book, with which he agreed. It also emphasized that relatively small differences in monetary policy had limited effects on developments over the period covered by the projections, although the effects beyond the projection period might be sizable. That the effects were so limited pointed to the futility of focusing too heavily on the relatively short run.

Continuing, Mr. Mayo noted that one of the more significant differences between the two projections was in the behavior of short-term interest rates: over the next three quarters, they rose appreciably more in the alternative projection. In view of the greater rise, the difference in the projected rate of housing starts appeared quite small. He asked whether changes in Regulation Q had been assumed for the alternative as well as for the basic projection.

Mr. Gramley replied that for both projections an increase of 50 basis points in the ceilings on longer-term certificates had been assumed to take effect at the beginning of 1976.

Mr. Mayo remarked that an adjustment of that size appeared inadequate to reduce disintermediation significantly. Moreover, many REIT's remained in a precarious position, and in the circumstances of the lower rate of monetary growth, more bankruptcies would be likely. Consequently, he thought that the rate of multifamily starts would be severely depressed. Altogether, he would guess that the level of housing starts in the staff's alternative projection was too high.

Mr. Gramley said he agreed that the assumed change in Regulation Q was inadequate to stem the tide of disintermediation. The assumption had been based on an estimate of what the savings and loan associations could afford to pay.

Mr. Bucher remarked that he had difficulty in reconciling the anticipated rate of increase in prices with the low--by historical standards--rates of capacity utilization for major materials and for manufacturing as a whole that were projected through 1976. Only part of the anticipated rise in prices, it seemed to him, could be explained by external factors and cost-push. The red book[1/] reported the comment of a director of the New York Bank that

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

"the current spending pattern, with consumers' outlays rising while business capital spending was not, could well have inflationary implications," which seemed to suggest that capacity was a near-term problem. He asked Mr. Gramley to comment.

Mr. Gramley observed that if a situation of strong expansion in consumer spending and sluggish business investment in plant and equipment persisted for a long time, the relationship between consumption and investment might well have inflationary implications. However, the present relationship was not at all unusual for this stage of the cycle. There were signs that business fixed investment plans were beginning to strengthen, and the staff anticipated that investment outlays would expand as the recovery proceeded. The relationship between investment outlays and consumption would change markedly over the course of the upswing, and it was not a significant factor in the staff's view of price prospects. The staff projection of prices had three major elements. First, upward pressures would come from production costs, with unit labor costs projected to rise at a 4-1/2 per cent annual rate over the six quarters of the projection period. Second, increases in prices of foods and fuels would have a significant impact on the over-all price level, mainly in the fourth quarter of this year and in the first quarter of 1976. And third, recent increases in prices of steel, aluminum, autos, and some industrial chemicals had led the staff to assume that some administered prices would be raised earlier than in previous postwar expansions, as businesses attempted to anticipate increases in costs. However, the third element was small relative to the first two.

Mr. Balles commented that past projections of interest rates and prices had been especially wide of the mark. In the second half of last year, for example, some problems had developed with respect to the econometric model's equations of the demand for money, and the projected rate for the 3-month Treasury bill had been considerably above the level that had actually prevailed. In viewing the staff's alternative projection today, he was disturbed by the prospect of double-digit short-term interest rates in the spring of next year. With respect to both interest rates and prices, he wondered whether the staff had a view about the range of error in the projections.

In response, Mr. Gramley said there was considerable uncertainty about the projections of interest rates, which were among the most difficult variables to forecast. As Committee members knew, the staff tended to make rather large judgmental adjustments to the interest rate projections produced by the model. In the latest projection based on the assumption of a 7-1/4 per cent rate of growth in M_1, for example, the model had produced a short-term interest rate in the fourth quarter of 1976 that was 2-3/4 percentage points above the staff's judgmentally projected rate. The latter might not be correct in terms of the exact dimensions of the prospective rise in short-term interest rates, but the projection clearly suggested that pressures in financial markets would be substantial if nominal GNP expanded more or less as anticipated and M_1 grew at the assumed rate. Both the basic and the alternative projections implied large increases in velocity; over the first four quarters of recovery, the implied increases were 6.8 per cent and 7.4 per cent, respectively, for the two projections.

Concerning prices, Mr. Gramley continued, there had been a tendency in staff projections of recent years to underestimate the amount of increase. At the moment, he felt considerable uncertainty about the projection of a 7-3/4 per cent rate of increase in compensation per manhour in the private nonfarm economy; the rate could well be higher. However, the bulge in the rate of increase in the price level might prove to be less than projected, if decontrol of domestic oil prices took place gradually over a 3- to 4-year period and if decontrol were accompanied by removal of the import fee in a way that left the average price of oil unaffected, apart from the impact of an increase in the price of OPEC oil.

Mr. Balles then remarked that, because of the great difficulty in projecting interest rates and prices, it might be desirable to present the projections in terms of a high, a low, and a most likely outcome. That would emphasize the wide range in which the actual figures might fall.

Mr. Gramley said the staff would give consideration to such a form of presentation.

In response to questions by Mr. Volcker, Mr. Gramley observed that the near-term outlook for economic activity had strengthened since the Committee had adopted its longer-run targets for the monetary aggregates, and the projected rise in prices had been revised upward mainly because of the much larger increases in prices of foods and fuels now in prospect. Consequently, the current staff projection implied more pressure on interest rates and more incentive for disintermediation. As a result, projected rates of growth in M_2 and M_3 were now lower in relation to growth in M_1. If M_1 were to grow at the 6-1/4 per cent midpoint of the Committee's longer-run range, M_2 and M_3 would grow at rates about 1 percentage point below the lower limits of their target ranges. If M_1 were to grow at a 7-1/4 per cent rate, M_2 and M_3 would grow at rates slightly above the lower limits of the ranges.

Mr. Volcker then noted that the staff had projected a strengthening in plant and equipment outlays, and he asked what the sources of strength would be, especially in view of the expected weakness in such outlays by public utilities.

In response, Mr. Gramley said the advance indicators of business fixed investment were beginning to suggest that an upturn would occur in the near future. For example, new orders for nondefense capital goods rose substantially in April, and after several months of stability at the increased rate, they rose somewhat further in July. New business formations and construction contract awards for commercial and industrial buildings had turned up. And in August, following a 10-month decline, output of business equipment rose nearly 2 per cent. More importantly, perhaps, past cyclical patterns suggested that an expansion in economic activity as strong as that projected for this and the next quarter would lead to a widespread reevaluation of needs for capacity. As far as the public utilities were concerned, the substantial volume of cancellations that had been reported applied to a period extending about 5 years ahead, not just to plans for 1976. Consequently, the cancellations were not inconsistent with prospective strength in capital outlays for business as a whole.

Mr. MacLaury remarked that, like Mr. Mayo, he had benefited from presentation of the alternative projection, and he hoped the staff would continue to present one. Unlike Mr. Mayo, he was impressed by the difference between the two projections. That difference emphasized, he believed, the wisdom of choosing the higher of the two paths for monetary growth over the period from the second quarter of this year to the second quarter of 1976. Even with growth in M_1 at a 7-1/4 per cent rate over that period, the blue book[1/] suggested that the rate would slow from about 7-3/4 per cent in the third and fourth quarters of this year to about 6-3/4 per cent in the first quarter of next year and to about 6-1/4 per cent in the second quarter. He asked whether the staff GNP projection was based on such a pattern of monetary growth or on a stable 7-1/4 per cent rate of growth throughout the period.

Mr. Axilrod replied that the GNP projection was based on the path of monetary growth suggested by the blue book. That involved a rate of growth in M_1 of about 7-1/4 per cent on the average over the projection period as a whole. The slower growth in the second half of the period was needed to offset the more rapid growth expected in the first half. Afterwards, growth in M_1 would be expected to return to around the 7-1/4 per cent rate.

Mr. MacLaury then asked why the decontrol of old domestic oil was viewed with such concern when gasoline and fuel oils had a relatively small weight in the consumer price index.

Mr. Gramley replied that higher prices for petroleum products would raise costs of production for goods and services

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

generally, and the staff had assumed that the cost increases would be reflected in price increases, dollar for dollar. Thus, the indirect as well as the direct effects on the over-all price level had to be taken into account.

Mr. Eastburn remarked that he was concerned about the unemployment situation, particularly because a substantial number of people had been unemployed for 15 weeks or more and because the staff projections suggested that the unemployment rate would remain high for an extended period. Pressures to take action--including monetary policy action--were likely to intensify, especially as the 1976 political campaigns got under way. Against that background, he asked for Chairman Burns' views on the possibilities that non-monetary actions would be taken and on whether the System ought to take a public position on the issue.

In response, Chairman Burns said he was uncertain how far the Committee would want to go in taking a position. In his testimony before the Joint Economic Committee on July 29, when he had spoken for the Board, he had put considerable emphasis on structural policies of a kind that would be much less likely than expansive fiscal and monetary policies to generate inflationary pressures. He did not know how much he had affected Congressional thinking. However, he would have another, and perhaps better, opportunity when he addressed an audience at the University of

Georgia later this week. On that occasion, he would deal with the question of unemployment in rather sharp terms and would present a plan for eliminating unemployment. Because the statement would be his own, it would be further advanced and bolder than the statement before the JEC, and therefore it might have more effect. However, he was not especially optimistic. Conventional thinking was likely to rule for some time, although--in his judgment--it had been misleading.

Mr. Baughman remarked that at a meeting on the preceding Thursday the directors of the Dallas Bank had expressed the view that the recovery was not proceeding as rapidly as they had expected, and the latest red book also seemed to have something of that tone. At the same time, the Dallas directors were unanimous in believing that the System should not take stimulative action. One of the directors representing large banks reported that loan demand was exceptionally weak; he was both surprised and distressed that the prime rate was being raised aggressively, and he believed that if the rate were pushed up to 8 per cent--which it subsequently was--it would be so out of line that it would have to come down again. Optimism was expressed by directors engaged in retailing, although they were concerned about the size of price increases being quoted on new orders.

Mr. Baughman then observed that it was especially difficult at this time to relate financial factors to real activity, because of the rate of increase in prices. Members of his staff had been doing some work that led them to feel that interest rates might not rise so much in relation to real activity as suggested by the projections presented to the Committee. He asked whether those projections were based on nominal GNP or personal income as a scale factor affecting money demand.

Mr. Gramley replied that the staff's interest rate projections depended on the relationship between growth in money and growth in nominal GNP. Personal income was used as a variable only in the monthly model, because no better monthly indicator of aggregate expenditures was available. However, it had not produced very good projections. Nominal GNP in relation to money demand was more reliable.

Mr. Baughman commented that, while the use of personal income produced greater monthly deviations between projected and actual interest rates, the deviations averaged out over several months. As he had suggested, increases in interest rates projected on the basis of growth in personal income rather than growth in nominal GNP were not so large in relation to expansion in real GNP. That led him to believe that the System could follow a policy course that would not involve as much of a rise in the Federal funds rate and in commercial paper rates as suggested by the staff projections.

Mr. Axilrod remarked that recent work done by the Board's staff indicated that in the first year of recovery interest rate projections based on nominal GNP were too high while those based on personal income were too low. In making its interest rate projections for the blue book, the staff had taken those results into account.

Mr. Partee added that by historical standards the projected rise in interest rates from the second quarter of this year to the second quarter of 1976 appeared large, given the expectation that real GNP would expand by about 7 per cent. In contrast with the first year of earlier expansions, however, prices also were expected to rise about 7 per cent. The unusual pressure on interest rates resulted from having to finance 7 per cent increases in both output and prices.

Chairman Burns commented that the need to finance a Federal budget deficit of $80 billion to $100 billion clearly was exerting an influence on interest rates.

Mr. Baughman then asked whether the expected rate of increase in prices might not already be reflected in the level of interest rates.

Mr. Partee replied that current interest rates certainly incorporated an inflation premium. Nevertheless, recovery in activity, inflation, and the large Federal budget deficit would generate such large financing requirements next year in relation to the assumed rate of monetary expansion that upward pressures on interest rates would be greater than in past periods of recovery. The flow of funds projections provided an idea of the magnitude of the problem. Total funds raised in the economy, which were at an annual rate of $172 billion in the first half of this year and were projected to rise only a little--to a rate of $179 billion--in the second half, were projected to expand to rates of $218 billion the first half of next year and $237 billion in the second half. In his view, the staff had been conservative in its projections of the rise in interest rates next year.

Mr. Wallich asked whether real interest rates entered into the model at all. Also, noting that current interest rates were unusually high, he asked whether the projected rates were extrapolations beyond the range on which the model was based and whether, for that reason, they were particularly uncertain.

Mr. Gramley replied that projections of both residential construction and business fixed investment were influenced by estimates of real interest rates, which reflected estimates of the expected rise in prices based on an extrapolation of the actual rate of increase over a relatively long period. With respect to Mr. Wallich's second question, current statistical relationships differed greatly from those in the period on which the model was based, so that the projections were extrapolations. For example, the money demand function was linear in the logarithms, meaning that economization of money balances was the same when interest rates moved from 8 to 16 per cent as when they moved from 2 to 4 per cent. The staff thought that was unreasonable, and consequently it had scaled down the projected rise in interest rates. Perhaps the staff had not gone far enough, but he could not be optimistic about the outlook for interest rates in light of prospects for activity and prices and in light of the assumption regarding monetary policy.

Mr. Volcker asked whether the year-to-year increase in total funds raised that Mr. Partee had cited was abnormally large for a recovery period and whether the projected saving rate was unusually high.

In response, Mr. Partee observed that the ratio of funds raised to GNP was projected to be higher in 1976 than in 1975, and he believed that an increase was typical in a period of recovery. With respect to the projected saving rate, it was high but not extraordinarily so. The staff had followed a practice of holding the rate fairly constant over the projection period except when there were good reasons to vary it.

Chairman Burns said he would cite statistics on the personal saving rate for a number of countries over a period of increasingly rapid inflation, without interpretation for the moment. For each country, he would cite the annual figures of saving as a per cent of disposable income for 1964, 1965, and 1966, and then for 1972 and 1973, and for 1974, except where the figures were not available. All were years of relatively low unemployment around the world. The figures were as follows:

	1964	1965	1966	1972	1973	1974
United States	6.0	6.0	6.4	6.6	8.2	7.9
United Kingdom	8.0	8.7	9.0	10.1	11.3	12.7
Germany	11.3	12.3	11.6	14.9	14.1	14.7
Japan	16.4	17.5	17.4	21.7	24.9	25 +
Canada	4.2	5.5	6.6	8.9	8.8	8.6
Australia	10.7	8.9	10.9	13.7	17.0	N.A.
France	11.1	11.7	11.7	13.3	14.2	13.3
Netherlands	15.0	14.9	14.3	15.7	16.2	N.A.
Italy	14.5	16.7	15.5	19.7	19.7	N.A.
Belgium	13.3	14.8	14.3	18.9	18.3	N.A.
Ireland	10.8	10.8	10.2	14.5	18.0	N.A.
Austria	10.0	9.5	9.9	11.8	14.0	N.A.
Sweden	7.7	6.0	5.4	5.7	7.6	N.A.

The Chairman observed that, with the exception of a few Scandanavian countries, the saving rate had increased from the first set of years to the second. And it might be significant that in Sweden, where the rate was lower in the second period than in the first, it nevertheless had increased from 1968-70 to 1971-73. He drew the inference that a quickening pace of inflation dampened rather than stimulated consumer spending, as a few students of consumer behavior--notably Katona--had been saying for a number of years. That raised questions about the pursuit of Keynesian policies in a world that had become non-Keynesian, because such policies rested basically on the assumption of a reasonably stable price level.

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 August 19 through September 10, 1975, and a supplemental report covering the period September 11 through 15, 1975. Copies of these reports have been placed in the files of the Committee.

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

> Desk operations sought to maintain steady conditions of reserve availability in the period since the August meeting. Federal funds were encouraged to trade generally in the 6-1/8 to 6-1/4 per cent area, while monetary growth was moderate--tending to the lower side of the specified range for M_1 and a shade below the Committee's M_2 range. Some of the financial markets were not so calm, however, as they reacted to shifting views about the strength of the recovery, inflation, System policy intentions, Treasury cash needs, and the New York City financial situation.

Long-term reserve needs were met during the interval through the purchase of about $1 billion in Treasury and Federal agency coupon issues. Outright bill holdings were up modestly--just under $200 million. Substantial temporary swings in reserve availability were offset through sizable, day-to-day repurchase agreements and matched sale-purchase transactions. The cumulative totals of each of these types of transactions exceeded $12 billion during the period. There would have been even greater need for these short-term transactions if the Treasury had not reduced the magnitude of its cash swings somewhat by employing, for the second consecutive month, a sale of very short-term bills. These bill sales have been accepted well by the market, and they are helpful to the Desk in reducing day-to-day reserve swings.

The steadiness in Federal funds rates in the past few weeks was paralleled in the Treasury bill market, where rates fluctuated narrowly around 6-1/2 per cent for 3-month issues and around 7 per cent for 6-month maturities. The bill market has continued to absorb sizable weekly increases in new bills at these rate levels, which have provided a sufficient margin above day-to-day financing costs to induce banks and others to add to holdings. A significant rise in the funds rate would probably find quick reflection in the bill market, although a gradual firming of funds to around 6-1/2 per cent might be accomplished with fairly moderate impact on the bill rate structure.

In the coupon market sentiment was at a low ebb at the time of the last meeting, as prices sagged under the weight of Treasury coupon offerings. In the latter part of August there was some improvement in prices as Treasury offerings abated and market participants concluded that System policy was not firming further for the time being. Desk purchases of coupon issues and press reports of System plans to continue such purchases also bolstered sentiment. Increasing caution and gloom developed in early September, however, in response to evidence of persistent inflation, renewed concern over heavy Treasury borrowing demands in the coupon area, and a feeling that monetary conditions are likely to firm in the months ahead. A further depressant has been the concern over New York City's problems. By the close of the interval, yields on intermediate- and longer-term issues were some 15 to 30 basis points higher than at the time of the August meeting.

The market is bidding today on $3 billion of a 2-year issue, raising $1 billion of new money. It was expected yesterday that the yield might be close to 8.50 per cent, which compares with 8.25 per cent for a similar maturity several weeks earlier. Next week the Treasury will sell $2 billion in a 29-month issue, all for new cash, while further cash is to be raised in coming weeks through a $3 billion sale of additional 2-year notes and a $2.5 billion sale of an intermediate-term issue.

This prospect of unremitting Treasury demands on the coupon market, together with the market view that money rates are likely to firm in the months ahead, has produced a very cautious and somewhat despondent attitude among dealers and investors. A marked increase in the funds rate, particularly if pressed quickly, could generate a sizable reaction in yields. A more gradual firming in funds, say to 6-1/2 per cent in the course of 2 weeks or so, would moderate the market reaction but probably not relieve it altogether. Even at current yields, Treasury coupon issues are attractive to individual investors.

In coming weeks large reserve needs are anticipated virtually whatever course the Committee adopts today, and this will provide further opportunities for Desk purchases of Treasury coupon and agency issues. In turn, such purchases could moderate upward rate adjustments. It would probably be counterproductive to attempt very aggressive purchases, however, as this would tend to produce a market view that Desk activity was encouraging artificial price levels. Such an attitude would cause other investors to stay away in droves. Moderate Desk purchases, though, could help the market to absorb Treasury offerings without excessive rate adjustments.

Finally, in regard to New York City, it has been noted in our reports that the market greeted with relief last week's action by the New York State legislature to provide temporary financial aid to the City, while imposing tighter fiscal discipline on the City through the new Emergency Financial Control Board. But there is no illusion that the present arrangements are more than a stopgap. The current plan can carry the City into early- or mid-December. Between now and then, investor attitudes will be shaped by budget plans and actions that market participants can observe as being consistent, or not, with the City's achieving a mandated budget balance by fiscal year 1978. Investor attitudes will determine whether the City can reenter the market on its own name. Meantime, even before December, the market will be making judgments about New York State's own creditworthiness in light of its added burdens to assist the City, and perhaps to assist various State-sponsored agencies that have experienced increasing difficulty in placing their debt. In the past month, there has been increasing concern among leading market participants that it may not be possible to confine the impact of New York's financial problems to the City itself and to a few State agencies. There is now more concern that the financing problem could impact severely on the State--which had been a very well-regarded credit--and on many other well-rated governmental borrowers.

Chairman Burns asked Mr. Sternlight if he thought the mandate imposed on New York City to achieve a balanced budget by fiscal 1978 would serve to restore confidence in the City's securities among investors around the country.

Mr. Sternlight said he thought investors would want to see evidence of substantial progress in implementing the mandate. Indeed, the City's credit standing would probably continue to be questioned even if such progress was being made. From an investor standpoint it would be preferable, of course, for New York City to attain a balanced budget by fiscal 1977. He believed it would be extremely difficult, if not impossible, for the City to balance its budget in fiscal 1976. Draconian measures would be required to achieve that result.

In reply to questions by Mr. Mitchell, Mr. Sternlight reported that the Standard and Poor's bond and credit rating agency, while commending New York State for its constructive actions to date in assisting the City, had warned the State that it would jeopardize its relatively high credit rating if it extended aid beyond that already committed. He could not recall a similar warning by a rating agency in the past.

In response to a question by the Chairman, Mr. Sternlight said he thought the agency's ratings had a considerable influence in shaping investor attitudes.

Mr. Holmes indicated that he agreed with Mr. Sternlight. While some people were a little skeptical about particular ratings, the agency was generally well regarded by investors.

Mr. Morris also indicated his agreement with that assessment. The staff of Standard and Poor's had been upgraded considerably over the past few years, and he thought they had the courage to resist political pressures and to put their convictions behind their ratings.

Mr. Kimbrel observed that Standard and Poor's exerted an influence of another kind in that their ratings were consulted by bank examiners in appraising securities held in bank portfolios. However, many local government issues were not rated.

Mr. Partee said he thought the practical effect of Standard and Poor's statement would be to reduce the attractiveness of New York State obligations to out-of-State investors. Many trustees, for example, probably would now be reluctant to buy the State's securities, because of the possibility that Standard and Poor's public warning could be used against them in future legal proceedings.

Two Reserve Bank Presidents indicated that many trustees in their Districts already were unwilling to buy New York State obligations.

Mr. Bucher observed that trustees tended to be overly cautious in such situations. When a question was raised about a particular security, the inclination was to remove securities of that general type from purchase lists. During the Penn Central crisis, for example, the commercial paper of many issuers was removed from purchase lists on the basis of unconfirmed rumors or vague feelings that there might be some relationship to a problem situation.

In reply to a question by Mr. Black, Mr. Sternlight said he would anticipate only a modest impact on short-term interest rates if the Federal funds rate were to move up gradually to 6-1/2 per cent over the course of the next week or two. There was a general expectation in the market that the Federal funds rate would rise over the next few months.

Mr. Black said he thought the probable market reaction to a rise in the Federal funds rate was one of the key questions before the Committee today. In his view the magnitude of that reaction would depend on whether the rise was accompanied by evidence of accelerating growth in the monetary aggregates.

Mr. Sternlight agreed. He noted in that connection that there apparently had been some pickup in the growth of the aggregates in early September.

Mr. Black observed that for September as a whole the Board staff was projecting a step-up in the rate of growth of M_1. However, the New York Bank projections suggested that the September growth rate would be about the same as that recorded for August.

Mr. Mayo asked for Mr. Sternlight's views about the implications of the Treasury's heavy financing schedule for System operations.

Mr. Sternlight said he thought the Committee would probably decide that it had to downgrade even keel considerations in light of the almost continuous schedule of Treasury financings. While the financings could not be disregarded altogether, he did not see how they could be given the same weight as in earlier years when Treasury financings had tended to be limited to quarterly refundings and only a few other major operations.

Mr. Mayo observed that the Treasury's successful expansion of the auction technique in marketing coupon issues served to reduce the need for even keel, and Mr. Sternlight agreed.

Mr. Bucher commented that New York City's financial problems appeared to have been eased, at least temporarily. As Mr. Sternlight had noted, however, various New York State-sponsored agencies were experiencing increasing financial difficulties. He asked Mr. Sternlight what he thought the repercussions might be of a default by one of those agencies in the weeks immediately ahead.

At this point the Chairman reminded the Committee and staff of the extremely sensitive nature of the discussion and of the need to avoid all references to it outside of the meeting. Indeed, System officials had to be cautious about making references to the New York situation even apart from what was said at Committee meetings. It was not his intention, however, to inhibit today's discussion in any way. On the contrary, the problem was one that the Committee had to discuss.

In response to Mr. Bucher's question, Mr. Sternlight remarked that the repercussions would depend upon the sort of default that might occur. The Urban Development Corporation's failure earlier in the year to meet an obligation on time had generated heightened concern about New York City and other State agencies but had not had generally drastic consequences. In the event of some future default by a State agency, if it was clear that efforts were being made in the State legislature or elsewhere to provide for a resumption of payments, the repercussions might be similarly limited. If, however, the market concluded that the State, financial institutions, or others were not going to intervene, the consequences were likely to be widespread. The State's own credit standing would surely be affected.

Mr. Morris observed that the financing problems of State agencies were not confined to those in New York. Last week the Massachusetts Housing Finance Agency, which was a very well managed operation, had not been able to roll over some $106 million in maturing bond anticipation notes. The underwriters had found that they could not market an issue of that size at any interest rate unless it carried the general obligation backing of the State. The State of Massachusetts had quickly passed the necessary legislation and the issue was sold. In the absence of such legislation a default would have occurred. He suspected that investors in other parts of the country were shying away from securities that did not have general obligation backing.

In reply to questions, Mr. Morris explained that the notes had been moral obligations of the State. It had taken the State only 2 days to pass legislation to provide for general obligation backing.

Chairman Burns remarked that such expeditious action was encouraging.

Mr. Volcker commented that in his judgment a default by a New York State agency could have more serious consequences than were envisioned by Mr. Sternlight. Such a default would reflect immediately upon the State's credit, which was already being questioned. The State had come fairly close to not being able to sell a general obligation issue in September and it had two further, if smaller, financings to undertake in October and November. If, in addition, the State was required to add its general obligation backing to State agency issues--which were very sizable--the repercussions could be serious. Fortunately, the State's own financing calendar would be relatively light until March. However, the State would then become a heavy borrower; from late March through June it would have to raise several billion dollars. It was to be hoped that the situation would have improved by that time.

In reply to a question, Mr. Volcker indicated that constitutional limitations on general obligation issues did not apply to short-term notes of State agencies. However, those agencies would not be able to issue bonds with general obligation backing.

In reply to a question by Mr. Jackson, Mr. Sternlight said he thought the New York State agencies had sizable maturities to refinance virtually every month. The New York State Housing Finance Agency had the largest financing needs--roughly $100 million around the middle of each month--but other State agencies also had frequent, if smaller, financing needs.

Mr. Volcker added that the New York City Housing Agency also had several maturing issues to refinance, including one in the near future.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 19 through September 15, 1975, were approved, ratified, and confirmed.

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

> The blue book alternatives[1/] all assume that the substantial recovery in the economy projected by the staff for the second half of this year will be reflected before long in further upward pressures on interest rates as credit demands strengthen and demands for money expand. Private credit demands in short-term markets over the past 2 months--while by no means strong--have been noticeably less weak than in the first half of the year. During recent months businesses have no longer been paying down short-term

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

debt at banks and in the commercial paper market, and there are some signs of a pick-up in demand. Also, consumer credit began to expand in early summer; this was reflected in increased demands on banks and most recently in increased borrowing by finance companies in the open market.

This turnaround in private short-term credit demands, together with the continued large amounts of new cash raised by the Treasury in the bill market during the summer, has been associated with a continued upcreep of short-term interest rates during the past few weeks, even though the Federal funds rate has shown no change from around 6-1/8 per cent since the second half of July. As a result, other short-term rates are now well above the funds rate. In June the funds rate had averaged 5-1/2 per cent, and average rates on 3-month Treasury bills, commercial paper, and bank CD's ranged from 20 basis points below to 10 basis points above that rate. By mid-September, these short-term rates were from 30 to 75 basis points above the funds rate.

Looking to the period immediately ahead, private demands on short-term credit markets are likely to pick up somewhat further, given the staff's GNP forecast. Moreover, Treasury borrowing requirements will be very large between now and the end of October--as noted in the staff documentation--with the bulk of the funds to be raised in bill and short-coupon areas. And banks, given some recovery in business and consumer loan demands, are unlikely to be in a position to absorb as many Treasury securities as they did in the first half of the year.

Thus, short-term interest rates are likely to be under further upward pressure over the next few months. Given the already fairly wide spread of other short-term rates above the funds rate, these additional pressures can hardly avoid being reflected in the Federal funds market since that is now the least-cost market. Under the circumstances, the Desk could be forced to provide very large amounts of nonborrowed reserves if the funds rate were to be held down. All of the alternatives presented to the Committee envisage a significant rise in the funds rate by at least late fall, and two of the three alternatives encompass a move in that direction over the next few weeks.

The interest rate patterns in the alternatives not only reflect the pressures of credit demand but also presume a rebound in money demand. For the past 2 months money growth has been quite modest, but this is because the money needs of the economy in that period had to a considerable extent been prefinanced by the very rapid build-up in cash balances during May and June, when M_1 grew at a 15 per cent annual rate. The 9 per cent annual rate of growth in M_1 over the 4-month May-August period is probably roughly indicative of underlying money demand.

The staff anticipates that M_1 will shortly begin expanding at a more rapid pace, particularly by October, when Treasury credit demands are especially large. If the Committee were to opt for little change in money market conditions over the next few weeks, Treasury borrowing would clearly be facilitated and impacts on private short-term rates minimized, at least for a while. But this would be at the risk of a larger-than-desired expansion in money. If the Committee wished to move significantly in the direction of tightening the funds rate, on the other hand, other interest rates might rise rather substantially in the period ahead in view of the very crowded Treasury financing schedule, but the odds on an undue expansion in bank reserves and money would clearly be reduced.

Mr. Black asked whether the third-quarter growth rate for M_1 might be subject to seasonal adjustment problems. The seasonally adjusted growth rates in the third quarter had been far below those of the second quarter in both 1973 and 1974, and the same pattern seemed likely this year.

Mr. Axilrod replied that, while there often were problems with the seasonal adjustment factors for M_1, the factors were reviewed annually, and in the latest review the staff had not found a seasonal adjustment problem of the kind Mr. Black suggested. He might note that the sharp fall-off from the second to the third quarter of 1975 appeared in the series based on figures for the final months of each quarter. However, on a quarterly average basis M_1 was expected to grow at a 7.7 per cent annual rate in the third quarter, only slightly less than the 8.6 per cent rate of the second quarter. The difference was related to the sharply rising trend of growth rates during the second quarter; in April, May, and June, respectively, M_1 increased at rates of 3.4, 11.3, and 18.7 per cent.

Mr. Partee observed that in both 1973 and 1974 monetary policy had been tightened just prior to the third quarter. In his view, therefore, the third-quarter slowing in those years should not be interpreted as reflecting a seasonal pattern.

Mr. Mitchell noted that bank loans had declined by nearly $12 billion during the first 8 months of the year while bank holdings of securities had risen by some $30 billion. He asked what the staff was projecting for bank credit growth over the balance of the year and how it expected such growth to be distributed between loans and investments.

Mr. Axilrod replied that the staff anticipated moderate growth in bank credit over the rest of 1975. As he had indicated in his statement, there were signs of a pick-up in business and consumer loan demands, and if the staff GNP projection was reasonably correct, some loan expansion could be anticipated over the balance of the year. The important change in the over-all loan situation, however, was that banks were not likely to experience the large loan repayments of the first half of the year when consumer credit was weak and businesses were reducing bank loans with the proceeds of capital market flotations and inventory liquidation. On the investment side, banks would probably show a diminished interest in Government securities, at least at prevailing interest rate levels. Indeed, if banks were to continue accumulating such securities at a rapid rate, they would need to sell CD's to help finance them. However, on the basis of past experience banks were not likely to go into the CD market to any significant degree except to finance business loan demands.

The Chairman then suggested that the Committee turn to its discussion of monetary policy and the directive after hearing whatever advice Mr. Partee had to offer.

Mr. Partee remarked that on returning from vacation recently he had been rather surprised both by the strength of the business situation and by the widened differential between the Federal funds rate and rates on private short-term market securities that had been created by increases in the latter. Although he had expected the economy to turn up in the third quarter, the statistics cited by Mr. Gramley indicated that the recovery under way was somewhat stronger than he had expected. There had been some question earlier about what would replace the fiscal policy measures of May and June as a continuing source of economic stimulus; the answer seemed to be that the stimulus was now developing from increases in employment and production within the private sector. With respect to interest rates, the current diffentials between the funds rate and other market rates provided an incentive to banks to adjust their positions by purchasing Federal funds rather than by liquidating securities carrying relatively higher interest rates.

To his mind, Mr. Partee continued, the combination of a strengthening business situation and a relatively low Federal funds rate increased the risk of another sizable increase in the money supply. Although the monetary aggregates were projected to grow in coming months at rates appreciably higher than experienced in July and August, the Committee had to be prepared for the possibility of an even stronger rebound. He was firmly convinced that the Committee's major problem during the fall would be the need to adjust to a higher level of interest rates, assuming that it wished to stay with the target ranges for the money supply that had been adopted. Accordingly, he would recommend that the Committee at least maintain the present level of interest rates--that it not ease money market conditions in any way--and that it take advantage of any opportunities that arose in the period ahead to allow interest rates to move up a bit. Such opportunities would, of course, be limited by the frequencey of Treasury financings and by market problems associated with New York City and New York State financing difficulties.

Mr. Mayo observed that he was quite pleased with the sound but slow economic recovery portrayed by the staff's projection and that he was satisfied with the 7-1/4 per cent longer-run M_1 path assumed in developing the projection. In that regard, he thought the Committee's decision to express its longer-run objectives for the aggregates in terms of ranges rather than specific growth rates had been a wise one. The ranges offered elbow room for variations without the need to modify announced targets which--like the 5 to 7-1/2 per cent range for M_1--had won widespread acceptance by the public and the Congress.

Turning to short-run objectives, Mr. Mayo said he preferred the specifications of alternative A. The 6-1/2 to 8-1/2 per cent range shown under that alternative for growth in M_1 in the September-October period struck him as reasonable, and he favored maintaining the current 5-3/4 to 7 per cent range for the Federal funds rate that was called for under A. As Mr. Partee had noted, the funds rate was now low relative to other market rates. Under current procedures, however, it was possible to track the aggregates from day to day, and if--as Mr. Partee suggested might be the case--the aggregates began to grow at excessive rates, the funds rate could be permitted to move up. He would be inclined to permit the rate to rise from the present 6-1/8 to 6-1/4 per cent area to the 6-3/8 per cent midpoint of its range, or perhaps a little higher, if M_1 appeared to be growing at a rate above the 8-1/2 per cent upper limit.

However, Mr. Mayo continued, he would not want to move aggressively to encourage a rise in the funds rate at this time. The System had provided reserves rather grudgingly over the past few months, and there were no excess reserves at present. More generally, there were no signs of excess liquidity in the economy, and if a problem arose as a result of increases in velocity, it could be dealt with at the time. It was also worth noting that a rise in the funds rate much above 6-1/2 per cent would immediately pose the question of whether the discount rate should be increased. While it was reasonable to expect to have to raise the discount rate at some point, such action had not been taken by any major industrial country except Canada. Finally, he thought the System should not put itself in the position of encouraging a rise in the funds rate immediately before the large Treasury financings that would occur during the coming weeks; it would be better to follow rather than to lead the market up.

Mr. Mayo remarked that if subtle increases in the Federal funds rate were needed they could be achieved despite the heavy Treasury financings in prospect. The effects of those financings apparently had already been largely discounted by the market; last week's announcement of additional Treasury borrowing of $3 billion to $6 billion had had less impact on interest rates than he would have anticipated. Even keel considerations warranted less emphasis than in the past for other reasons also, including the types of financing in prospect, their frequency, and the use of the auction technique--which, incidentally, he now regretted had not been adopted more widely 20 years ago, when he was with the Treasury.

In sum, Mr. Mayo observed, he would await evidence that M_1 was growing at a rate above the 8-1/2 per cent upper limit of the alternative A range before encouraging a rise in the funds rate. He thought a 5-3/4 to 7 per cent funds rate range would provide the Desk with a proper degree of flexibility, but if it were considered too wide he could accept a range of 6 to 7 or even 6 to 6-3/4 per cent.

Mr. Coldwell remarked that on the basis of the available evidence he was prepared to accept the view that a recovery was under way. But he continued to be disturbed by some aspects of the situation--particularly the high level interest rates and the rate of price advance--which conceivably could lead to developments that would abort the recovery. He was concerned also about the possible consequences for interest rates of New York City's fiscal problems and of the heavy volume of Treasury financing, as well as of the increase in business loan demand that now appeared likely. A crucial question for the Committee was whether monetary policy could be expected to moderate the impact of such cost and interest rate pressures.

Mr. Coldwell noted that he had attempted to assess the probable effects on key variables of various policy alternatives. Starting with the table presented by Mr. Gramley showing projections on the assumptions of 6-1/4 and 7-1/4 per cent longer-run growth rates for M_1, he had used simple linear extrapolation in order to estimate the effects of an 8-1/4 per cent M_1 growth rate. For the period covered by the projections, the differences in outcomes based on a 6-1/4 versus an 8-1/4 per cent M_1 growth rate were rather small; by the fourth quarter of 1976, the 8-1/4 per cent M_1 path resulted in an inflation rate .6 of one percentage point higher and an unemployment rate .8 of one percentage point lower than the 6-1/4 per cent path. The margin would, of course, widen if the projection period were extended.

In light of the prospective heavy volume of Treasury financing and the over-all sensitivity and uncertainty in financial markets, Mr. Coldwell observed, he thought a stable Federal Reserve posture would be appropriate for the near term. It might prove desirable to foster some increase in the rate of growth in M_1, possibly through a change in reserve requirements. On the other hand, Mr. Partee's expectation that the money supply would begin to grow at an excessive rate might be borne out. He would like to see evidence of that development before moving toward a firmer monetary policy.

Accordingly, Mr. Coldwell said, he favored maintaining the Federal funds rate within rather narrow bounds; he would not want to see the weekly-average funds rate move below 6 per cent or above 6-1/2 per cent unless the monetary aggregates were growing at rates substantially lower or higher than now expected. For the 2-month ranges of growth in the monetary aggregates, he liked the specifications of alternative A, except that he would reduce the lower limit of the M_1 range to 5-1/2 per cent.

Mr. Holland observed that his policy prescription was similar to Mr. Mayo's. He regarded the specifications of alternative A as consistent with the GNP projections, and he thought Mr. Mayo's suggested procedure with respect to the funds rate was appropriate, although he would be a bit more willing to allow some upward movement in the funds rate during the coming inter-meeting interval.

Mr. Morris remarked that he too favored alternative A, but for reasons somewhat different from those advanced by Mr. Mayo. Because the current economic situation was unprecedented, he would expect greater margins of error in the projections than had been typical in the past. Accordingly, he was troubled by alternatives B and C; if the Committee adopted either, it would be changing policy on the basis of projections rather than on the basis of available data. M_1 had grown at the moderate rate of 4-1/2 per cent in August, and according to the New York Bank's projections, it would continue to grow at about that rate in September. In light of the probability of greater forecast errors in such an unprecedented period, he thought the Committee should place more weight on hard evidence and less weight on projections. That consideration led him to support alternative A strongly. The 7 per cent upper limit for the Federal funds rate under that alternative would provide ample leeway for Desk operations to respond during the inter-meeting period if the monetary aggregates should begin to grow rapidly.

Mr. Bucher observed that Mr. Partee's comments had accurately reflected his own thinking on monetary policy. He too believed that the Committee had to be aware of the need to adjust to a higher level of interest rates. In fact, were it not for the unsettled situation in financial markets, he might have argued that the Committee should move overtly in the direction of restraint rather than await opportunities to raise the funds rate, as Mr. Partee had suggested. But he could not ignore what was apparently the concern of the financial markets in general--the combination of New York City's difficulties with a renewal of inflationary expectations. Those considerations led him to accept the specifications of alternative A, with the hope that near-term crises could be surmounted and that at the same time the funds rate would be moved a little higher, toward the upper limit of the range specified under A.

With respect to the longer-run targets, Mr. Bucher said, he was prepared for the time being to accept the 7-1/4 per cent M_1 growth path assumed in the green book projections. He shared the concern others had expressed about the implications of that course for GNP growth and unemployment, particularly in the third and fourth quarters of 1976. He believed, however, that there was little the Committee could do about that situation at this point.

Chairman Burns remarked that his views were not very far from those of Mr. Partee. He thought some edging up in the Federal funds rate would be wise at this time because, as Mr. Partee had indicated, the opportunities to do so in the near future might be limited. He would suggest a funds rate range of 6 to 7-1/4 per cent--or possibly 6 to 7 per cent, although he had some preference for the former. Since it was necessary to proceed cautiously in light of the sensitive state of financial markets, it would be understood that the Desk would not aim for a funds rate in the upper part of the range without a reaffirmation of the Committee's intent; if the rate were approaching that area--and it might not--he would consult with the Committee before the Desk proceeded further. For the monetary aggregates, he would reduce the lower limits of the 2-month ranges below those shown under any of the blue book alternatives; specifically, he would suggest ranges of 5 to 8 per cent for M_1 and 7 to 9-1/2 per cent for M_2.

Mr. Eastburn said he had found Mr. Partee's comments to be quite pertinent, and he liked the specifications the Chairman had suggested. As the Committee would recall, at the July meeting he had mentioned estimates by his staff which indicated that the funds rate would have to increase by about 40 basis points per month through next June in order to achieve the Committee's longer-run M_1 target over the period ending then. In the 2 months since July the funds rate had remained about unchanged; moreover, the rebound in economic activity had become stronger. Consequently, it now appeared that increases in the funds rate on the order of 60 basis points per month would be needed to achieve the longer-run M_1 goal.

Such estimates obviously were quite rough, Mr. Eastburn observed. However, they did underscore an important point--the longer that interest rates remained at their current levels, the larger the increases that would be required later on. Although he agreed that the Committee should not try to push the funds rate up at this time, he thought it should be prepared to respond quickly when the rate of growth of the aggregates indicated the need for a rise. In his judgment, the Committee had made mistakes in the past by not moving the funds rate as promptly and aggressively as necessary to control the aggregates. He would not want the Committee to instruct the Desk to hold the funds rate in the lower part of its specified range, as it had last month. If the Committee now adopted a range of 6 to 7 per cent--which was his preference--he thought the full width of that range should be used as needed to achieve the desired rates of growth in the aggregates.

Mr. Mitchell remarked that he would be generally satisfied with the policy course recommended by Mr. Mayo, and he had no objection to the modifications of the alternative A specifications suggested by the Chairman. He would favor taking advantage of opportunities to raise the Federal funds rate, but not before the need for such a move was confirmed by indications that the aggregates were growing rapidly. Also, he shared the view that the delicate state of financial markets--reflecting primarily the problems of New York City--called for considerable caution in the conduct of monetary policy, since System actions could exacerbate that situation.

In addition, Mr. Mitchell continued, he might mention two other considerations. First, if the business upturn should prove to be gathering momentum, a change in the discount rate might well be appropriate. Before his term of office ended--and that would not be long from now--he would like to see the discount rate in a reasonable relationship to market interest rates. That had not been the case during most of his 14-year term. Secondly, he would like the Committee and its staff to study the possibility of focusing the impact of monetary policy on the area of time and savings accounts. Under such an approach, particular objectives could be achieved with policy actions that were less visible and that had a smaller impact on reserves. The approach probably would involve increases in the ceiling rates on time and savings accounts, to allow the financial intermediaries to compete effectively with Treasury offerings. Under the usual approach, the System reacted to disintermediation by supplying a large volume of reserves, and that had a substantial effect on the rate of growth of the narrowly defined money supply. He thought that result could be avoided while retaining the benefit of greater credit availability. In his judgment, the credit proxy would become a very important number in the months ahead.

Mr. Wallich commented that he usually was torn between a desire to keep the Federal funds rate low and a desire to keep the growth rate in the money supply low. Today he found himself in the opposite dilemma. The economy had been performing better than expected--real GNP evidently was growing at about an 8 per cent rate--but inflation had been worse than anticipated. Unfortunately, the higher rate of inflation called for a more prolonged period of slack in the economy than previously envisioned and put a damper on the prospects for recovery; continuation of an 8 per cent growth rate in real GNP for several quarters would be dangerous. Since he saw some reason for not encouraging further exuberance in the rate of economic expansion, he favored allowing the funds rate to rise somewhat over the period immediately ahead. The New York City situation would not deter him from that course because the critical moment in that situation probably lay several months in the future. When it occurred, the Committee might well be happy that it had acted earlier and, therefore, that it was not then confronted with a need to raise interest rates.

On the other hand, Mr. Wallich continued, the higher rate of inflation--which he hoped would be short-lived--seemed to call for a certain amount of accommodation. He would favor a middle course, accepting a little more inflation and a little less real output. Consequently, he would not be disturbed if M_1 were to grow at a rate within the alternative A range. Specifically, he would favor a 2-month range for M_1 growth of 6 to 8-1/2 per cent. He thought that would be consistent with the 6 to 7-1/2 per cent funds rate range of alternative B.

Mr. MacLaury said he felt comfortable with the 7-1/4 per cent longer-run M_1 path underlying the staff's recent GNP projections. As he had noted, that path implied some slowing in the rate of growth over the months ahead. He would also repeat the suggestion he had made at the previous meeting that the Committee specify its longer-run objectives for the aggregates in terms of desired levels rather than rates of growth. Such a procedure would avoid confusion regarding the implications that any future data revisions might have for the longer-run targets.

Chairman Burns noted that at the next meeting the Committee would be considering that question in connection with its review of the longer-run targets.

Continuing, Mr. MacLaury observed that he would like to minimize the risk that a rapid rise in interest rates would be needed later in the year in order to remain on the desired longer-run M_1 path. He saw no reason to raise the funds rate in anticipation of excessive increases in the aggregates, but like Mr. Eastburn, he thought the Committee should be prepared to react quickly when such increases appeared, as he believed they would. Furthermore, he was concerned about the procedure of specifying ranges for the funds rate and then issuing supplementary instructions to the Manager which, in effect, involved a fixed target. At the last meeting, for example, the Manager had been instructed not to move the funds rate very far up within its specified range without further deliberation by the Committee.

Chairman Burns remarked that during the past month estimates of growth in the aggregates had been quite low relative to the ranges specified, so that an increase in the funds would not have been warranted. In fact, those estimates would have supported some reduction in the funds rate, but the members had concurred in his recommendation that such a reduction not be sought.

Mr. MacLaury said he did not mean to criticize the manner in which operations had actually been carried out; his comments were directed at the nature of the Committee's instructions. As a matter of principle, he believed that the range for the funds rate should mean what that term implied--that the full range should be available to the Desk as it responded to changes in the aggregates. With respect to specifications for the coming period, he would prefer the ranges for the aggregates shown under alternative B but he could accept those suggested by the Chairman. For the Federal funds rate he favored a range of 6 to 7 per cent with the understanding that the full range could be used if necessary.

Mr. Kimbrel expressed concern about the apparent resurgence in inflationary expectations. Actual and anticipated price advances, particularly for food and energy-related items, were taking a toll on consumer confidence, and there were indications that businessmen were becoming more cautious in their spending plans because of uncertainties about prices. In addition, some businessmen were anxious about the possibility of new price control legislation. Committee policy actions that would help allay concerns about inflation would be worthwhile. He was troubled also by evidence of current demands, as well as rumors of future demands, for large wage increases--in some cases, for extraordinarily large increases--even though unemployment remained high.

If the economic recovery proceeded as projected, Mr. Kimbrel continued, the demands for credit were likely to increase. That, together with renewed inflationary expectations, would exert upward pressure on interest rates. While he recognized that Treasury financing would be heavy in the inter-meeting period, he gathered from Mr. Sternlight's remarks that it probably would be feasible to raise the funds rate somewhat without disrupting financial markets, so long as the operation was carried out carefully. He would be inclined to move in that direction. Specifically, he favored a range of 6 to 7-1/4 per cent for the funds rate. He hoped that the funds rate would not drop below its current 6-1/8 per cent level, and that it would be increased to about 6-5/8 or 6-3/4 per cent over the next 2 or 3 weeks. For the aggregates, he preferred the alternative B ranges, but he would have no difficulty in accepting those suggested by Chairman Burns.

Mr. Volcker remarked that, while the economy appeared to be expanding rather vigorously at present, he was not at all sure about the degree to which the upward momentum would carry through to 1976. The recovery might be truncated or aborted by tight money and high interest rates, by rapid inflation, or by a variety of other factors.

Under the circumstances, Mr. Volcker observed, he would not want to undertake a marked tightening of money market conditions at the present time. He certainly would not want to ease money market conditions, and for that reason he thought a reduction in the lower limits of the short-run ranges for the monetary aggregates, as suggested by the Chairman, would be a step in the right direction. Indeed, he thought the lower limits might be eliminated entirely for the coming inter-meeting period; he would not want the Federal funds rate to decline during the next few weeks no matter how weak the monetary aggregates might appear to be in the short run. In any event, some reduction in the lower limits would be particularly important at present because the New York Bank's projections of the aggregates were considerably below those of the Board for the short run, although not for the longer run.

Mr. Volcker said he had planned to suggest that if the Committee wanted to snug up money market conditions a bit, this was as good a time as any. For one thing, the New York City crisis had been temporarily allayed; for another, it would be just as well for the Committee to take any such action before, rather than after, the Treasury had carried out all of the financing operations scheduled for the next several weeks. However, he would not press that case. He would be reluctant to foster a large increase in the Federal funds rate--into, say, the 6-3/4 to 7 per cent area--without deliberating carefully about the matter and without considering the desirability of accompanying any such action with an increase in the discount rate. Accordingly, he would prefer not to set the upper limit of the range for the funds rate at 7 or 7-1/4 per cent. He could agree to a 6 to 7 per cent range if it were understood that the upper part would be used only after the sort of consultation the Chairman had suggested. However, he would be a little happier if the upper limit were set at 6-3/4 per cent, so that an explicit Committee decision would be needed before the Desk would aim for a higher rate.

Mr. Baughman said he thought the draft directive cast in terms of the monetary aggregates was preferable to the alternatives in terms of money market conditions because the former was consistent with the manner in which the Committee had expressed its longer-term policy goals. Because there was more uncertainty than usual about the relationships between interest rates and rates of growth in the aggregates at this stage of the cycle, it might be desirable for the Committee to permit a fair amount of variability in the funds rate between meetings. However, if the Committee focused primarily on the funds rate in the effort to achieve its objectives for the aggregates, it would not make much sense to think in terms of wide variations in the funds rate. On the other hand, if the Committee focused directly on the aggregates, considerable variation in the funds rate should certainly be expected.

At present, Mr. Baughman continued, he thought operations should be directed at achieving a growth rate in M_1 as close as possible to the upper end of the 5 to 7-1/2 per cent range that had been announced as the Committee's longer-term target. At the same time, he would not want M_1 growth to exceed that range to any significant degree. Accordingly, he favored a range of 6-1/2 to 7-1/2 per cent for the M_1 growth rate in the September-October period. He shared the view that the funds rate should not be permitted to decline in the coming period, but he would be willing to accept any increases that were found necessary to constrain monetary growth within the target range.

Mr. Balles noted that the Committee had been successful in its effort to slow growth in M_1 from the rapid rates in May and June; in the following 2 months the growth rate had averaged only 3 per cent. Largely as a result of developments in that period, he was somewhat skeptical about the relationships underlying the specifications in the current blue book. In particular, he was inclined to think that the aggregates would not expand as rapidly as the blue book indicated, primarily because the monetary base had grown at a rate of only about 4-1/2 per cent from the end of June until the end of August.

Accordingly, Mr. Balles observed, he believed that the alternative A range for the Federal funds rate--5-3/4 to 7 per cent--

was likely to prove consistent with the alternative B ranges for the aggregates, which were acceptable to him. Like Mr. Morris, he would not want to raise the range for the Federal funds rate until there was firm evidence that the aggregates were exceeding the Committee's targets. The analysis in the green and blue books suggested that it might be necessary for monetary policy to accommodate some supply-induced increases in prices, but in that connection also he would prefer to wait for the expected developments to occur before reacting.

Mr. Balles remarked that the sensitive state of financial markets also contributed to his view that relative stability in short-term interest rates would be desirable, at least until the next meeting of the Committee. As he had indicated, he would prefer the alternative A range for the funds rate, in the belief that that would not result in growth in the aggregates at rates as high as those shown under A in the blue book.

Mr. Francis said his main concern at present was that Federal Reserve policy might follow the same pattern it had in similar situations in the past decade, when policy had remained unduly expansive until prices began to react, and had then tightened sharply enough to precipitate another period of recession. He therefore favored the aggregate targets of alternative C. According to the blue book, that policy course would result in successive declines in quarterly rates of M_1 growth, from 7.7 per cent in the current quarter to 4.9 per cent in the second quarter of 1976; over the whole period from the second quarter of 1975 to the second quarter of 1976, the growth rate would be 6.3 per cent. He might note that in recent years the trend rate of growth in money had been in the neighborhood of 6 per cent. In his judgment, the alternative C policy course would not involve great risk of aborting the recovery, which he viewed as strong. It would, however, increase the chances of avoiding another acceleration of price advances, followed by another period of recession.

Chairman Burns remarked that Mr. Francis' observation about recent history was a useful one. The Federal Reserve had made serious mistakes because it had been unwilling--for thoroughly understandable reasons--to act early enough in the course of economic expansions. At present, he shared the reluctance expressed by a number of Committee members to see an increase in the Federal funds rate. He would, however, be willing to go a little further than most of those who had spoken thus far, because he was concerned that the Committee might otherwise find that it had compounded its difficulties.

Mr. Winn said he shared the Chairman's concern. As he looked ahead, however, he wondered whether the System had any weapons left to deal with the situation it would be facing; the outcome--in terms of employment, prices, and interest rates--appeared likely to be unsatisfactory no matter what longer-term policy course the System followed. Accordingly, he thought it might be desirable for the members to spend some time thinking about possible alternatives to monetary policy as a means of coping with the problems that lay ahead.

The Chairman noted that at its next meeting the Committee would be devoting more than the usual amount of time to the economic outlook, in connection with its review of the longer-run targets. That might be an appropriate occasion for the members to express their views on structural policies. As he had indicated earlier, he would be commenting on that subject later this week in an address at the University of Georgia. If the Committee as a whole had some definite views on the subject it might wish to consider issuing a pronouncement. Alternatively, he might make the Committee's position known in the course of coming testimony before the Senate Banking Committee.

Mr. Jackson said he agreed with those who believed that the Federal funds rate would have to rise over coming months and that the System should take advantage of whatever opportunities might occur to foster increases in that rate. Like Mr. MacLaury, he thought the Desk should have somewhat more freedom than it had been given at the previous meeting to move the funds rate toward the upper limit of the range specified if that was justified by rapid growth in the aggregates. At present, he favored the specifications for the aggregates shown under alternative B. For the funds rate he favored a range of 6 to 7 per cent, on the understanding that the Committee would be consulted before a rate in excess of 6-3/4 per cent was sought.

Mr. Black remarked that he wanted to endorse Mr. Francis' comments about the errors the System had made in the past through its reluctance to tighten policy as early as desirable during economic expansions. However, he also shared Mr. Volcker's views about the danger that the current recovery might be aborted, either by inflation or by turmoil in financial markets. Because of that danger, he thought the Committee did not have much maneuverability at the moment, although that was largely a matter of timing. Finally, he concurred in Mr. Balles' judgment that the projections of strength in the monetary aggregates should be viewed with skepticism, and that a higher Federal funds rate should not be sought until there was definite evidence that the aggregates were overshooting the Committee's targets. If the aggregates did show unusual strength he would be prepared to have the funds rate increased rather promptly. For the operational paragraph of the directive he would retain the present wording which focused on the aggregates.

Mr. Clay observed that, in order to accommodate the developing recovery in business activity, he would like to see interest rates remain near their present levels; and in order to reduce the threat to sustainable economic growth that was posed by resurging inflation, he would like to avoid rapid growth in the monetary aggregates. For the September-October growth rates in the aggregates, he preferred the specifications shown under alternative C, including the range of 5-1/2 to 7-1/2 per cent for M_1. He thought the range for the funds rate shown under alternative B--6 to 7-1/2 per cent--would be consistent with such growth rates. While he favored the B range for the funds rate, initially he would prefer to see that rate held generally between 6-1/4 and 6-1/2 per cent. Finally, he would prefer a directive cast in terms of the monetary aggregates that would allow the funds rate to increase within its tolerance range if the aggregates began to grow at rates in the upper part of their tolerance ranges.

Chairman Burns asked whether the Committee favored language for the operational paragraph of the directive like that adopted at the previous meeting, which called for seeking conditions consistent with "moderate growth in monetary aggregates over the months ahead."

A majority of the members responded affirmatively.

In response to further questions by the Chairman, a majority of the members indicated that they would find acceptable 2-month ranges for growth rates in M_1 and M_2 of 5 to 8 per cent and 7 to 9-1/2 per cent, respectively, and the range for RPD's that the staff determined was consistent with those ranges for the monetary aggregates.

Chairman Burns then said he had the impression from the Committee's discussion that a range of 6 to 7 per cent for the Federal funds rate would be generally acceptable, on the understanding that the Committee would be consulted before the Desk aimed at a funds rate in excess of 6-3/4 per cent.

At Mr. Coldwell's suggestion, the Chairman asked the members to indicate whether they would prefer to have the consultation take place before the funds rate exceeded 6-1/2 per cent, rather than 6-3/4 per cent.

A majority of the members expressed a preference for 6-3/4 per cent.

Reverting to the directive, Chairman Burns noted that the staff suggested a modification in one sentence of the draft of the general paragraphs, in order to take account of the latest data. Specifically, the staff suggested that the exchange value of the dollar be said to have "risen somewhat further" rather than to have "changed little on balance" in recent weeks.

There was general agreement with that suggestion.

Chairman Burns then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs with the change just agreed upon, and the same operational paragraph as that adopted at the previous meeting. 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 September-October period would be 5 to 8 per cent for M_1, 7 to 9-1/2 per cent for M_2, and the range for RPD's determined to be consistent with those figures. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 6 to 7 per cent, with the understanding that the Chairman would consult with the Committee before the Desk aimed at a Federal funds rate in excess of 6-3/4 per cent.

> By unanimous vote, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

> The information reviewed at this meeting suggests that output of goods and services--which had turned up in the second quarter--is increasing appreciably further in the current quarter. In August industrial production and nonfarm payroll employment expanded at a faster pace than in July, and the average workweek in manufacturing continued to lengthen. The unemployment rate remained at 8.4 per cent, as the civilian labor force increased about as much as total employment. Retail sales apparently declined slightly, following 4 months of large gains.

The index of wholesale prices of industrial commodities rose somewhat more in August than in July, chiefly because of increases in prices of energy products; prices of farm and food products declined slightly. The advance in average wage rates over recent months has been somewhat less rapid than in 1974 and early 1975.

In recent weeks the exchange value of the dollar against leading foreign currencies has risen somewhat further. In July the U.S. foreign trade surplus declined from the very high second-quarter level, as imports rose sharply. Bank-reported capital movements showed a net inflow, in contrast to the net outflows of earlier months, while U.S. liabilities to foreign official agencies, which earlier had been rising, declined.

Expansion in M_1 picked up somewhat in August from the low July rate. Growth in M_2 and M_3 slowed further, however, as inflows of consumer-type time and savings deposits to banks and to nonbank thrift institutions continued to moderate, reflecting in part the increased attractiveness of alternative investments. Interest rates on short-term securities and on longer-term Treasury and corporate securities have shown little net change in recent weeks, except that longer-term yields adjusted upward following the Treasury's September 10 announcement of its sizable borrowing requirements over the rest of this year. Yields on State and local government securities rose to new highs in early September, as a result of widespread concern about possible repercussions of New York City's financial crisis; on September 9 a State program to assist the City was enacted.

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

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

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

Chairman Burns then noted that recent meetings of the Committee had tended to take a considerable amount of time. Because of the importance of ensuring that adequate time was available for the Committee's deliberations, the members might want to consider advancing the customary starting time from 9:30 a.m. to 9:00 a.m.

After some discussion, it was agreed that the starting time should be advanced.

It was agreed that the next meeting of the Committee would be held on October 21, 1975, at 9:00 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida

Secretary

ATTACHMENT A

Robert Solomon
September 11, 1975

Meeting of Working Party 3, September 5, 1975

The Working Party held a brief meeting on the last day of the Fund and Bank week. The main topic was the evolution, past and future, of the current account balance-of-payments positions of the OECD countries and of other groups of countries.

A new set of estimates prepared by the OECD Secretariat revised downward rather drastically the current deficit (goods and services plus private and official transfers) of the OECD countries--to \$6-1/2 billion for 1975, compared with \$35 billion in 1974. For the first half of 1975 an actual surplus (\$2-1/2 billion annual rate) is estimated, to be followed by a deficit of \$15-1/2 billion in the second half.

The big change in the OECD position in 1975--both from the actual outcome for 1974 and from earlier forecasts--is the result of the recession in the major OECD countries, which has caused the largest drop in world trade in the postwar period: the volume of imports into OECD countries fell almost one-fifth (annual rate) in the first half of 1975.

All of the reduction of the OECD deficit in the first half of 1975 was accounted for by the six largest countries; the United States alone showed a swing of \$16 billion, at annual rates, from a current deficit of \$3-1/2 billion in the second half of 1974 to a surplus of \$12-1/2 billion in the first half of this year.

Only Germany, Canada, and Belgium failed to experience an "improvement" in the current balance.

A large portion, perhaps three-fourths, of the "improved" OECD position was reflected in a reduction in the surplus of OPEC countries. The remainder shows up as enlarged deficits of developing countries, which managed to maintain their imports in the face of sharply declining export volumes and prices. There are doubts about how long non-oil LDC's can sustain such deficits (estimated at more than $25 billion, over and above receipts of grant aid, in 1975).

The implications of these estimates were quite clear. Recovery from the recession will throw the OECD countries back into substantial deficit with OPEC (though not necessarily all the way, since OPEC imports are growing and oil demand in OECD countries may be reflecting not only the recession but also the high price of oil). Meanwhile, the developing countries and the smaller OECD countries have a serious financing problem.

Projected Effects of a 6-1/4 Per Cent M_1
Growth Target on Key Economic
and Financial Variables

	1975		1976			
	Q3	Q4	Q1	Q2	Q3	Q4
Commercial Paper Rate						
(Per cent)						
1. Greenbook Projection		8-3/4		10-1/2		11-1/4
2. 6-1/4% M_1 Growth		9-1/2		12-1/2		11-1/2
Real GNP Growth						
(Per cent, Annual Rate)						
1. Greenbook Projection	7.9	7.8	6.1	5.4	4.8	4.0
2. 6-1/4% M_1 Growth	7.9	7.6	5.6	4.5	3.6	2.9
Real GNP Level						
(Billions of 1958 Dollars)						
1. Greenbook Projection	798.2	813.3	825.4	836.4	846.2	854.6
2. 6-1/4% M_1 Growth	798.2	813.0	824.2	833.3	840.7	846.7
Unemployment Rate						
(Per cent)						
1. Greenbook Projection	8.4	8.1	7.9	7.7	7.6	7.5
2. 6-1/4% M_1 Growth	8.4	8.1	7.9	7.8	7.8	7.9

ATTACHMENT B

Projected Effects of a 6-1/4 Per Cent M_1
Growth Target on Key Economic
and Financial Variables

	1975		1976			
	Q3	Q4	Q1	Q2	Q3	Q4
Fixed Weight Deflator for Gross Private Product (Per cent Increase, Annual Rate)						
1. Greenbook Projection	7.4	7.4	7.7	5.8	5.4	4.9
2. 6-1/4% M_1 Growth	7.4	7.4	7.7	5.7	5.2	4.6
Housing Starts (Millions of Units, Annual Rate)						
1. Greenbook Projection	1.23	1.40	1.50	1.45	1.45	1.40
2. 6-1/4% M_1 Growth	1.23	1.40	1.45	1.40	1.35	1.25

ATTACHMENT C

September 15, 1975

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 16, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that output of goods and services--which had turned up in the second quarter--is increasing appreciably further in the current quarter. In August industrial production and nonfarm payroll employment expanded at a faster pace than in July, and the average workweek in manufacturing continued to lengthen. The unemployment rate remained at 8.4 per cent, as the civilian labor force increased about as much as total employment. Retail sales apparently declined slightly, following 4 months of large gains. The index of wholesale prices of industrial commodities rose somewhat more in August than in July, chiefly because of increases in prices of energy products; prices of farm and food products declined slightly. The advance in average wage rates over recent months has been somewhat less rapid than in 1974 and early 1975.

In recent weeks the exchange value of the dollar against leading foreign currencies has changed little on balance. In July the U.S. foreign trade surplus declined from the very high second-quarter level, as imports rose sharply. Bank-reported capital movements showed a net inflow, in contrast to the net outflows of earlier months, while U.S. liabilities to foreign official agencies, which earlier had been rising, declined.

Expansion in M_1 picked up somewhat in August from the low July rate. Growth in M_2 and M_3 slowed further, however, as inflows of consumer-type time and savings deposits to banks and to nonbank thrift institutions continued to moderate, reflecting in part the increased attractiveness of alternative investments. Interest rates on short-term securities and on longer-term Treasury and corporate securities have shown little net change in recent weeks, except that longer-term yields adjusted upward following the Treasury's September 10 announcement of its sizable borrowing requirements over the rest of this year. Yields on State and local government securities rose to new highs in early September, as a result of widespread concern about possible repercussions of New York City's financial crisis; on September 9 a State program to assist the City was enacted.

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

OPERATIONAL PARAGRAPH

"Monetary Aggregate" Proposal

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

Alternative "Money Market" Proposals

Alternative A

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

Alternative B

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

Alternative C

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

ATTACHMENT D

September 16, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications
A. Desired longer-run growth rate ranges (as agreed, 7/15/75): (QII '75 to QII '76)	M_1	5 to 7-1/2%
	M_2	8-1/2 to 10-1/2%
	M_3	10 to 12%
	Proxy	6-1/2 to 9-1/2%
B. Short-run operating constraints (as agreed, 9/16/75):		
1. Range of tolerance for RPD growth rate (September-October average)		1 to 4%
2. Ranges of tolerance for monetary aggregates (September-October avg.)	M_1	5 to 8%
	M_2	7 to 9-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		6 to 7%
4. Federal funds rate to be moved in an orderly way within range of toleration.		

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

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