

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, June 23, 1970, at 9:00 a m.

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

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Craven, Gramley, Hersey, Hocter, Jones, Parthemos, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Bernard, Assistant Secretary, Office of the Secretary, Board of Governors

6/23/70

-2-

Messrs. Wernick and Williams, Advisers,
Division of Research and Statistics,
Board of Governors
Mr. Keir, Associate Adviser, Division of
Research and Statistics, Board of
Governors
Mr. Wendel, Chief, Government Finance Section,
Division of Research and Statistics, Board
of Governors
Miss Ormsby, Special Assistant, Office of the
Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant,
Office of the Secretary, Board of Governors

Messrs. Baughman and Strothman, First Vice
Presidents, Federal Reserve Banks of
Chicago and Minneapolis, respectively
Messrs. Eisenmenger, Taylor, and Tow, Senior
Vice Presidents, Federal Reserve Banks of
Boston, Atlanta, and Kansas City,
respectively
Messrs. Scheld and Green, Vice Presidents,
Federal Reserve Banks of Chicago and
Dallas, respectively
Messrs. Gustus and Kareken, Economic Advisers,
Federal Reserve Banks of Philadelphia and
Minneapolis, respectively
Mr. Davis, Adviser, Federal Reserve Bank of
New York
Mr. Meek, Assistant Vice President, Federal
Reserve Bank of New York

Chairman Burns reported that in a meeting this morning the Board had amended Regulation Q to suspend rate ceilings on CD's in denominations of \$100,000 or more with maturities of 30 through 89 days, effective tomorrow. In connection with that action, the Chairman said, the Board had found helpful the comments of the Reserve Bank Presidents in their joint meeting yesterday morning.

6/23/70

-3-

At the Chairman's request, Mr. Holland read the text of the press release announcing the Board's action that would be issued later today.^{1/} He noted that copies would be available shortly for distribution to the members. On the assumption that the Committee would want to take the Board's action into account in formulating both the language of its directive and its objectives for rates of growth in the aggregates, the staff had prepared supplementary notes bearing on those questions, which also would be distributed. Finally, in addition to the three alternatives for the second paragraph of the directive that had been included in the draft materials supplied to Committee members yesterday, the text of a fourth alternative, labeled "D", would be distributed.^{2/}

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on May 26, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on May 26, 1970, was accepted.

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

^{1/} A copy of the release is appended to this memorandum as Attachment A.

^{2/} The alternative draft directives submitted for Committee consideration and distributed on June 22 are appended to this memorandum as Attachment B; the supplementary notes, as Attachment C; and the text of the fourth directive alternative, as Attachment D.

6/23/70

-4-

the Committee. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts and tables have been placed in the files of the Committee.

Mr. Partee made the following introductory statement:

At this time of the year, the staff extends its forecasting horizon an additional two quarters to include the full fiscal year ahead. On this occasion, we do so with an acute sense of the existing uncertainties regarding the probable course of economic and financial developments. We are traveling now through uncharted territory. Past experience provides only limited guidance as to the significance of some of the dramatic recent developments in financial markets, where marked changes in asset values may be affecting business and consumer confidence to a degree that we do not yet fully appreciate.

In developing our GNP projection, we have assumed continued moderate growth in the monetary aggregates--with the money stock increasing at a 4 per cent annual rate. We believe this would have been associated with about a 7 per cent rate of increase in bank credit, on the assumption of no change in Regulation Q ceilings. Of course, we could not take into account this morning's Board action partially suspending the ceilings, which, while it remains in effect, should result in somewhat higher growth rates for time deposits and bank credit than we have projected.

As for the Federal budget, we have assumed national income account expenditures at \$210 billion for the fiscal year. This is a little higher than the level implied by the midyear budget review, mainly because we have added the increase in social security benefits already passed by the House to become effective in January 1971. But we have not allowed for further additions of programs or expenditures not now in the budget, nor for the possibility that new reductions in defense outlays may become possible. Given the slow rise of Treasury revenues produced by our GNP forecast, the NIA deficit for the fiscal year would be about \$6 billion.

Evaluated on a high employment basis, however, our budget assumptions would imply increasing fiscal restraint from here on out. In recent quarters, the high employment budget surplus has diminished, and there will be a small deficit in the current quarter. But given our expenditure assumptions, this budget would begin shifting toward surplus after midyear and the size of the surplus would increase substantially in the first half of 1971.

Mr. Gramley then made the following comments on recent developments:

The economic adjustment under way since last summer has thus far been quite mild in comparison with earlier post-war recessions. Industrial production has fallen about 3 per cent since the peak last July. Over a comparable time span in the 1960-61 recession, the fall was nearly twice as large. Total manhours worked in nonagricultural industries since July of 1969 have declined very little, with a significant reduction in manufacturing counterbalanced by fairly strong gains in other sectors. In recent months, the picture has weakened, as reductions in the workweek were widespread in May and overtime hours fell to the lowest level in more than 5 years. Nevertheless, total manhours had declined considerably more during a comparable time span in the 1960-61 recession.

The stability in total manhours worked has been a key factor sustaining aggregate wage and salary payments in manufacturing, mining, and construction since last July, a notable contrast to the drop in 1960-61. Of course, continued large wage rate increases in this recent period have also helped to keep total wage and salary payments at a high level.

The better maintenance of economic activity in this recent period, however, has not prevented a rise in the unemployment rate about as large as that in 1960-61, though from a lower base. The substantial increase in unemployment since late last year is mainly the result of large layoffs in manufacturing, but reflects also an unusually rapid growth in the labor force with new entrants less able to obtain employment.

The mildness of the current economic adjustment has occurred despite an appreciable drag from a decline in the rate of inventory investment--amounting to nearly \$10 billion since the third quarter of last year. A large part of the reduction has been in consumer durables and in defense-related products. In contrast, the decline from the cyclical peak to the trough in the 1960-61 recession amounted to only about \$7-1/2 billion, excluding the high rate of inventory buildup in late 1959 and early 1960 that was related to the earlier steel strike. The explanation of the over-all mildness of the current economic adjustment, therefore, must be sought in the pattern of final sales.

In the 1960-61 recession, total private final sales measured in 1958 dollars declined in 2 of the 3 recession quarters. Last year, the growth of real private final sales weakened in the third quarter, when auto sales and residential construction activity fell, but then picked up again.

The better performance of final sales in the current period is partly related to the fact that real growth in business fixed investment expenditures, though weakening, remained positive through the latter half of 1969. In earlier cyclical downturns, such as 1960-61, these expenditures responded more sensitively to developing economic weakness, perhaps because inflationary expectations were less firmly held than they have been recently.

Additionally, real personal consumption expenditures since the third quarter of last year have remained quite strong for a period of sluggish economic activity--with the rate of growth increasing in each of the past two completed quarters. By contrast, real consumption declined, on balance, over the three recession quarters of 1960-61. Much of the strength since last fall has represented increased purchases of nondurable goods and services--and has reflected continued sizable gains in disposable incomes.

Despite the relative strength of private final sales, inventory imbalances have developed along familiar cyclical lines at durable goods manufacturers. The stock-sales ratio has risen about as much as it did in 1960-61, with large increases occurring last fall in defense industries and more recently among producers of machinery and equipment. Ratios of inventories to unfilled orders of durable goods manufacturers have risen even more, due partly to the prolonged drop in order backlogs for defense goods. But, as yet, the percentage of manufacturers who view their inventories as excessive has not increased as much as in earlier post-war recessions.

At retail outlets, the stock-sales ratio for durables is a little above that at the end of the 1960-61 recession. But this ratio has been trending down from its January peak, as excess auto inventories have been worked off.

Over all, inventories of durables do not appear badly out of line with current sales. But there is little basis for anticipating a stimulus to production from an early return to high rates of accumulation, barring a strong revival of durable goods purchases.

Trends in new orders for durables do not suggest that such a revival is likely. Total new orders have been approximately level for the past several months, following an earlier decline roughly equivalent to that in 1966-67. This pattern would not seem to imply an incipient upturn in the rate of inventory accumulation, but neither does it suggest a serious deterioration in the outlook for inventory investment.

Orders for machinery and equipment, on the other hand, have shown somewhat greater weakness than the total. These orders have dropped about as much as in 1966-67--when the orders decline was followed by an absolute fall in business fixed investment. Given the continued relative strength of construction contracts for commercial and industrial buildings this year, the weakness in orders does not indicate a sharp downturn in plant and equipment spending in the near term. But it does suggest that the investment boom of recent years is over.

We are inclined, therefore, to discount the results of the recent Commerce-SEC anticipations survey, which shows a significant further rise in anticipated outlays through the third quarter of this year. This survey overstated actual expenditures in the first quarter by 3-1/2 per cent--a miss that cannot readily be explained by supply constraints.

In the past, as the 1960-61 experience indicates, such misses at turning points generally have been followed by several successive quarters in which actual expenditures fell below earlier anticipations, and substantial downward revisions were made in anticipated outlays. Given the imperative character of demands for capital among public utilities and communications firms, however, we may see less deterioration this year than in 1960-61.

In appraising the outlook for business spending, the role of financial variables must be considered quite as carefully as that of the usual nonfinancial indicators. The behavior of the stock market is of fundamental importance this year. Although the market has been in a downtrend since late 1968, equity prices did not begin to plummet until early April of this year. It will be some months yet before the effects of this recent market shake-out on business confidence and spending intentions can be discerned.

We are equally uncertain as to how greatly consumer spending may be affected by the recent stock price decline. There is no doubt, however, that this development--which has reduced asset values by something like \$150 billion

since the beginning of this year--will have a depressing influence on consumer purchases, especially of durables. For consumer spending too, the full impact of the stock market collapse has yet to be fully realized.

Currently high interest rates will also exert a restraining influence on spending in the period ahead. Despite resumption of growth in money and bank credit and the further weakening of real economic activity this year, interest rates have remained unusually high. Indeed, rates on corporate new issues and on State and local government bonds have recently risen to new peaks, producing further postponements in the municipal and corporate bond markets. In addition, we are hearing reports increasingly that high interest rates on mortgages have become a greater deterrent to would-be home buyers.

The behavior of interest rates this year has been heavily influenced by expectations. But the extraordinarily high level at which interest rates have remained may also be related to the liquidity effects of past constraints on the growth of the money stock.

While the nominal money stock has risen considerably in recent months, the present level is less than 3 per cent above that of a year ago. Over this past year, meanwhile, prices have risen in the range of 5 to 6 per cent.

If we measure the money stock in real terms, using the consumer price level as the deflator, we find that the real money stock has declined substantially since the beginning of 1969, and is now back to the level prevailing about the middle of 1967.

As noted earlier, our GNP projection assumes growth in the nominal money stock at a 4 per cent annual rate. To permit this amount of growth in money balances, and the rise in time deposits that would accompany it, reserves would need to increase at a little more than a 4 per cent annual rate.

Since consumer prices will undoubtedly rise at an average rate of at least 4 per cent over the remainder of this year, the growth rate of nominal money assumed here would not provide for any increase in the real stock of money before early next year. Consequently, monetary velocity would need to rise somewhat further to accommodate the growth in real income and expenditure that we are projecting.

Past experience indicates that a small rise in the income velocity of money usually is accompanied by relative stability of short-term interest rates. Consequently, we are projecting 3-month bill yields, which are seasonally

a little low now, to stay in a range of 6-3/4 to 7 per cent over the projection period. Though continued large demands for long-term credit by corporations and State and local governments will work against any substantial easing in long-term markets, long-term rates might edge down from recent peaks--to perhaps 8-3/4 per cent or so for Aaa corporate new issues and to 6-1/2 per cent for State and local issues--possibly lower, if expectations improve. However, lenders are becoming more quality conscious, and some potential borrowers may face increasing credit costs even if over-all market yields decline.

Given these interest rates and the Regulation Q ceilings in effect prior to this morning's Board action, commercial bank time deposits would be likely to grow at about an 8 to 9 per cent rate during the second half of this year and the first half of 1971. Banks could not issue large CD's in volume, given these assumptions, but consumer-type time certificates would continue to be an important source of funds. We would also expect the nonbank thrift institutions to experience a rate of inflow of time and savings deposits at about the pace of recent months--that is, at about a 6 per cent annual rate.

The bank deposit flows we have projected would be consistent with expansion in bank credit, adjusted for loan sales to affiliates, at approximately a 7 per cent annual rate. This would be moderate growth by historical standards. It would not flood the banking system with liquidity, but it would permit banks to participate more fully in the mortgage and municipal security markets, and would, over time, encourage some relaxation in bank lending terms to businesses.

Mr. Wernick then presented the following review of the staff's projection:

Our staff projection continues to indicate a near-term pickup in real growth, based mainly on the belief that the drag from a declining rate of inventory investment is largely behind us. The outlook for inventories is, of course, clouded by potential strikes in autos this year and in steel in 1971. Excluding strike distortions, inventory investment should, on balance, add to over-all growth in the year ahead--but the buildup is projected to be much milder than in past cyclical rebounds.

In part, this inventory projection rests on our expectations of only modest growth in private final sales. Quarterly increases in these purchases are expected to remain about the same as in the past three quarters--with greater strength in some sectors of private spending offsetting weakness in others. Moreover, currently high stock-sales ratios in durable goods manufacturing, continuing high interest rates, and further liquidation of defense inventories should also serve to limit over-all inventory investment in the coming year.

Business expenditures for fixed investment are likely to be a weaker element of spending, as the prolonged boom in capital outlays, which has exerted such strong upward pressures on resources and prices, appears to be ending. Profits are down sharply and may go lower; the stock market has shaken expectations; interest rates are high, and excess capacity has increased appreciably. We expect the dollar volume of business fixed investment, therefore, to level off soon and to decline through mid-1971.

With prices for capital equipment expected to continue rising, the projected decline in real investment--measured in 1968 dollars--is considerably steeper. In fact, in real terms, the upward trend in fixed investment has already come to a halt. This has been reflected in a decline in the output of business equipment since the peak last fall, and a corresponding reduction in manhours worked in the machinery industries.

One of the important factors helping to restrict business capital outlays has been the developing tightness in corporate financial positions. During 1969 and early 1970, total investment outlays of corporations, including inventory investment, reached extraordinarily high levels. With profit positions eroding, the gap between total investment outlays and internal funds increased greatly through 1969, and has narrowed only slightly since then.

Corporations, therefore, were required to raise a record volume of funds from external sources and they turned increasingly to bonds and stocks as their liquidity positions worsened and short-term debt mounted rapidly.

We believe the peak period of corporate external financing requirements is now behind us, since there has already been retrenchment in inventory investment and capital outlays are thought to be peaking. But with corporate profits projected to remain quite weak, the gap

between internal funds and investment outlays will still remain very large by historical standards, and the total amount of external finance will be heavy. Bond and stock offerings may recede a little from their recent high levels, but we expect a relatively heavy volume of long-term security issues for some time to come, in view of the desires of many corporations to restructure debt.

The strength of corporate demands for long-term credit will limit the supply of funds for residential construction over the next year. Nonetheless, we expect housing starts to begin rising soon, and residential construction outlays to advance appreciably later this year and in the first half of 1971. The availability of private mortgage funds should improve somewhat because of larger inflows of time deposits into banks and nonbank savings institutions. Even though interest rates on mortgages are not likely to decline much over the next year, the backlogs of demand for housing have increased markedly, and a significant response to the greater availability of funds thus seems likely.

State and local construction outlays are also projected to show more strength. Ceilings on bond interest rates have been eased or eliminated in a number of States and the markets for municipal securities should improve somewhat with the greater availability of funds expected from commercial banks. In this sector, too, intense demands for highway and other construction projects will almost certainly assure a rise in activity as more funds become available.

In the consumer sector, expenditures recently have been growing by about \$10 billion to \$11 billion a quarter. The moderate size of these gains points to cautious attitudes of consumers, given the earlier large increases in income related to the turn-of-the-year reduction in the surcharge, and, more recently, the increase in social security benefits and the Federal pay raise. The savings rate is certain to jump sharply this quarter.

Elimination of the surcharge in the third quarter will bolster consumer purchasing power, but high unemployment, sluggish employment growth, and the depressed stock market will likely continue to dampen spending. There seems to be little basis in the economic picture for any sharp rebound in consumer confidence, so that we think gains in spending will remain relatively moderate throughout the projection period. We do expect the savings rate to fall from the recent peak, in response to projected slower growth in disposable income, to about 6-1/2 per cent by the second quarter of 1971.

Because of further declines in defense outlays, Federal purchases of goods and services are not expected to add to over-all growth in demand over the next fiscal year. Recent press reports indicate possible further large cuts in defense spending in fiscal 1972. Such reductions, if they materialize, might lower spending somewhat more in the first half of calendar 1971 than we project. Nondefense purchases, however, are expected to grow a little more rapidly over the next 12 months than they have recently, so that total Federal purchases would be about level in the first half of 1971.

State and local purchases also are projected to rise somewhat faster. In addition to the step-up in expenditures for construction, spending for the whole array of current public services is likely to accelerate in response to growing public pressures and the increased availability of Federal grants-in-aid.

Summing up, the projected path of GNP growth in the coming year reflects a number of conflicting trends. A moderate step-up in inventory accumulation, following the recent sharp decline, sustained growth in consumer spending, and rising residential construction and State and local purchases should serve to bolster aggregate demand. But these sources of strength do not seem very vigorous and probable declines in business fixed capital spending and in defense outlays will serve to limit the upswing. We expect, therefore, to see increases in current dollar GNP holding at around \$15 billion per quarter through the first half of 1971.

In real terms, growth is expected to resume in the third quarter, and to pick up somewhat thereafter. But the projected gains of 2-1/2 to 3 per cent in the fourth quarter and beyond would still be well below potential growth in resources, with a consequent further rise in unemployment and additional declines in capacity utilization rates.

If real output grows as slowly as projected, total employment gains would continue relatively small throughout the next year. In fact, employment in manufacturing would probably continue to edge down until early 1971. In sectors such as State and local government and private services, however, employment should continue to rise at a fairly steady pace.

Growth in the civilian labor force--projected at 1.8 million over the next year, including men discharged from the Armed Forces--would be below the unusually rapid

rate in the first half of this year. But the rise projected for the labor force is still considerably larger than the anticipated increase in employment.

Consequently, the unemployment rate is projected to continue rising, though much less rapidly than in recent months, to about 5-1/2 per cent by year's end and to 6 per cent by mid-1971. This would be the highest rate of unemployment since late 1961.

Employment cutbacks thus far this year have been especially large in manufacturing, and one result is that productivity in this sector, which had shown little growth during most of 1969, has apparently taken a turn for the better. As profit margins deteriorated, employers began releasing some of their excess work force, and employment and the workweek were cut more sharply than output.

The rate of increase in average compensation per man-hour since the first of the year has moderated very little--even though there have been reductions in overtime pay and sharp employment cuts in high wage industries--because wage increases in new contracts have continued very large. Thus, it has been mainly the higher productivity gains that have led to the recent leveling off in unit labor costs--one of the first solid bits of evidence that production costs are responding to the slowdown in economic activity.

These productivity developments in manufacturing should begin to be reflected over the next year more generally in the economy. Since real growth is projected to resume, we anticipate a strengthening of productivity gains in the total private economy to a 2-1/2 per cent rate--much better than in the past two years but still below the long-run trend.

A softer labor market and higher unemployment should tend to weaken the relative bargaining position of workers, particularly in non-union sectors, where individual wage agreements predominate. This should mean a more moderate rate of growth in compensation per manhour, with the average perhaps dropping a shade below 6 per cent.

We thus expect unit labor costs to show an appreciably smaller rise over the next year than in the past twelve months. The projected increase of about 3.5 per cent from the second quarter 1970 to the second quarter 1971 is still considerable, but we would be moving toward a significant moderation in the rate of price inflation.

The key role played by reduced labor market pressures in slowing price increases is evident in past cyclical fluctuations. When unemployment rose sharply, as in 1957-58, the rate of increase of the GNP deflator moderated substantially. During the long period of excess demand that ended last year, the labor market had become considerably tighter, and labor costs had risen more rapidly and pervasively, than at any time since World War II. It is not surprising, therefore, that cost pressures have become so embedded in the price-wage structure.

We now expect, however, that the rise in the unemployment rate, together with the expected slowing of the rise in unit labor costs and the continuing slack in commodity markets, will have an appreciable impact on the rate of price inflation over the period ahead.

Food prices have already leveled off and wholesale prices of industrial commodities have begun to show signs of easing. Prospects are that the advance in the CPI will also slow in the months ahead. By the second quarter of 1971, we expect that the rise in the GNP deflator will have slowed to a little below a 3 per cent annual rate.

Mr. Hersey then presented the following statement on international developments and the U.S. balance of payments:

Events abroad are relevant here not only on account of their varied effects on the U.S. balance of payments but also because they influence the climate of inflationary expectations. Since mid-1967, economic activity in Western Europe has been expanding vigorously. Demand has grown to boom proportions, and a wage-price spiral is now developing. In particular, West Germany's growth has given stimulus to the whole area. In the past three quarters, while industrial production was falling off here, it was continuing to rise in Germany and in Europe generally--and also in Japan. There are no signs of a general downturn ahead, and we estimate that Western European industrial output will rise another 6 per cent in the coming twelve months.

Our present projections of industrial activity abroad and of world trade are, in general, at least as bullish as those we made last February. In Germany, backlogs of unfilled orders, especially for capital

goods, continue to expand. Even after last October's DM revaluation, new export orders, which had bulged before, still exceed current deliveries. In the field of prices and costs, the 9 per cent rise in DM prices for capital goods since a year ago is a happening without precedent in the past decade and a half. Consumer prices are up less than 4 per cent, while hourly earnings in industry have advanced about 14 per cent in a year, giving workers large gains in real income.

Until last year, the competitive position of the United States in relation to Germany and Japan had been worsening for a number of years, as suggested by indexes of export unit values converted to dollar equivalents. That German exporters have had ample profit margins is evidenced by the fact that even after the DM revaluation of 9 per cent, dollar prices of German exports in the first quarter of 1970 were up only 7 per cent from a year earlier, giving the exporters a gross return, after allowance for changes in border taxes, up by only 2 or 3 per cent. Japanese export prices have also risen considerably, but so have ours, along with our domestic prices. Thus, it is too early to see any improvement in the U.S. competitive position. We have yet to achieve the degree of price stability we seek.

The appreciation of the Canadian dollar's exchange rate this month is welcome, especially insofar as it shows greater acceptance of the idea that when a country has a persistent balance of payments surplus it should adjust its exchange rate. For over two and a half years now, Canada has had a trade surplus of unprecedented size. No doubt this is partly cyclical: while monetary and fiscal restraints have been holding down Canadian imports, the unsustainably high level of exports in the first quarter reflects boom conditions in Europe and Japan. But whatever the causes, the Canadian balance of payments, with a growing inflow of long-term capital, became very strong this year. Official reserves shot up by \$1 billion in the first five months, partly as the result of a return flow to Canada of commercial banks' funds and other private short-term capital.

The world boom has brought exceptionally high long-term interest rates everywhere. The rise in Britain since 1968 is partly a direct result of fiscal and monetary policy efforts to squeeze bank liquidity and force

a reduction in the banking system's holdings of Government debt. Germany's long-term interest rates have also risen, but are no longer far above ours.

The sharp rise in German short-term rates up to February illustrates strikingly the intensification of German monetary policy since a year ago. After the DM revaluation, short-term capital outflows put strong pressure on bank liquidity. The central bank welcomed this, and took further actions to restrain credit expansion and raise interest rates. In Britain, on the other hand, the favorable turn in the balance of payments permitted reductions in Bank rate in March and April, with a general decline in other rates. Meanwhile, Euro-dollar rates, which had been falling, turned up in April and May and have been around 9-1/2 per cent in June. Pressures in the German and other continental money markets seem to have been mainly responsible for the widened spread in recent months of Euro-dollar above U.S. money market rates.

Since last summer, with interruptions, there has been a gradual decline in the use of high-cost Euro-dollar money by U. S. banks. Total outstanding liabilities are still more than \$2 billion above the May 1969 level. Those heavy users which are in danger of losing their reserve-free privileges on borrowings not in excess of May 1969 levels have now about \$1-1/2 billion of leeway. Given our monetary policy assumptions and our expectation that European monetary policies will remain stringent, we expect the decline to continue.

The tables distributed project the U. S. balance of payments in 1970 as involving a \$5-1/2 billion deficit on what we call the "adjusted over-all" basis before inclusion of the SDR allocation--that is, the amount to be financed by official reserve transactions or by increasing liabilities to foreign commercial banks (including U. S. branches). Actually, liabilities to foreign commercial banks have been declining, and if they decline moderately further official reserve transactions for the year 1970 could be of the order of \$8 billion before SDR allocation. Approximately half of that amount was actually experienced through May. Liabilities to foreign reserve holders increased by over \$2 billion, while other reserve assets fell by nearly \$2 billion, the drop being mainly in currency holdings of the Federal Reserve and the Treasury. To avoid undesirably large increases in liabilities to foreign reserve holders later in the year, it may be necessary for the United States

to draw further on the IMF and to sell gold and SDR's. The deficit we are now projecting for 1970 is somewhat larger than we allowed for last February, mainly because April and May developments lead us to assume more net outflows of private liquid funds and less net inflows of foreign money to buy U. S. stocks and corporate bonds.

Our projection of the current account is a bit more favorable than last February's. From second half of 1969 to second half of 1970, the annual rate of net exports of goods and services would rise by \$2 billion. Merchandise exports would rise by 7 per cent in value, and imports by 4 per cent, with little or no rise in the next several months. Also, the investment income balance would improve a little, partly on account of the decline since last year in dollar interest rates. We are unable, however, to see a continuing improvement in 1971, when the projected acceleration of real GNP growth implies that imports will be picking up again. To achieve a goods and services balance of the needed size is going to take time.

In conclusion, I return to the question of what effect events abroad have had and may have on price inflation in this country. The worldwide capital goods boom of the last few years has stimulated U. S. exports--as the worldwide boom of 1955-56 also did--and with metals prices once again far above the levels to which they had fallen by 1958, demands for metals have been contributing to both cost-push and demand-pull everywhere. Inventories of metal and metal content at various stages of processing and fabrication have surely been built up here and abroad on a substantial scale. Though aggregate demand for finished products is continuing to grow in Europe, there are various indications that demand for nonferrous metals, as well as for steel, may have begun to be overtaken by growth of supply. If this is so, U. S. exports of machinery could still be increasing while the pressures in world metals markets might be easing.

Mr. Partee concluded the presentation with the following comments:

The GNP projection presented today shows a somewhat weaker economy during the remainder of 1970 than was portrayed in recent green books.^{1/} The extension of our

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

horizon to include the first half of 1971, given the assumed stance of monetary and fiscal policy, suggests that the rate of real growth will increase a bit more after the turn of the year, but still remain well below our long-run production potential. In these circumstances, industrial production would show only a moderate increase, corporate profits would remain depressed, employment gains would continue to be modest, and the unemployment rate would rise, probably to about 6 per cent by mid-1971.

I should emphasize again the great uncertainty surrounding this forecast. The timing and the magnitude of the upturn are still problematical, and the risks seem substantial that recent turbulence in financial markets could reduce spending plans more than we have allowed for.

The chances of this would be heightened if the bond markets remain as tight as they are now. Our flow-of-funds projection suggests that basic demand-supply factors would provide room for some reduction in long-term interest rates--though the decline probably would be moderate, in view of corporate desires to fund short-term debt, and the needs of State and local governments for long-term funds. But even this projected decline in long-term rates might not be realized if present market sentiment persists.

In formulating interest rate expectations, market participants have been focusing heavily on the size of Federal borrowing expected for the second half of this year. According to our estimates, budgetary borrowing should be about \$4 billion more than last year. Borrowing of Federally sponsored agencies outside the budget, while receding from previous record levels, also is expected to remain sizable. Though total Federal demands would thus be large, they would be below the highs of the second half of 1967.

Nevertheless, market participants appear to feel that the bulk of the securities will have to be placed outside the banking system, given a policy of moderate monetary expansion. Our flow-of-funds projection suggests that a 7 per cent growth rate of bank credit would permit banks to acquire a significant portion of the total, and that market participants are overestimating the probable interest rate pressures associated with forthcoming Federal credit demands. But these expectations are likely to persist for some time yet, and they will tend to hold interest rates up and to restrict financing and spending plans.

Our projection of business fixed investment already allows for some downward adjustment in spending due to financial pressures. Projected second- and third-quarter increases are below those indicated in the last Commerce-SEC survey, and we expect an outright decline beginning in the fourth quarter. By the first half of next year the decline in real investment would be considerable, although a good deal more moderate than in past recessions. There is obviously room for a still sharper fall, given the expected weakness in corporate profits, the low level of corporate liquidity, current levels of interest rates, and the effects on business confidence of the break in the stock market.

We have tried to take into account judgmentally the effect of the stock market slide on consumption by keeping the savings rate at higher levels than we would otherwise expect in a period of below-normal income growth. However, our econometric model suggests that if stock prices stayed at the second-quarter level, rather than rising along the path predicted by the model, the direct effect on consumption would reduce gains in these outlays by \$1-1/2 billion to \$2-1/2 billion per quarter. Implicitly, therefore, our judgmental projection would seem to require a continuation of the recent upturn in equity prices--and that may or may not occur.

Inventory investment is the other key sector that will shape importantly the timing and strength of the projected economic recovery. Stock/sales ratios do not appear so high, nor business sales expectations so pessimistic, as to justify outright liquidation of inventories. But here, too, our econometric model forecasts a weaker performance. In the February chart show, the judgmental inventory projection for the first quarter turned out to be too high; the econometric model was closer to the mark. It could be that the model is again telling us something of substance.

As we review the principal underpinnings of our GNP projection, therefore, we are impressed by the fact that in three key sectors of private spending--business fixed investment, consumption, and inventories--the possibility of a short-fall from our point estimates appears to be much greater than that of an over-run. Thus, the major risks seem to us to be on the downside. And even if our projection were realized, real GNP growth would fall well short of its potential and the unemployment rate, already up sharply, would be rising further throughout the projection period.

In the light of these findings, we have considered the possible effects of a somewhat easier monetary policy--one in which growth in the nominal money stock proceeds at a 6 per cent rate in the second half of this year, and then gradually returns to a 4 per cent growth rate by mid-1971. By the middle of next year, the stock of money under this more expansive assumption would be about \$2-1/2 billion higher than the level resulting from a 4 per cent growth path.

We estimate that additional growth of demand and time deposits consistent with this higher rate of monetary expansion would provide the basis for an additional \$6 billion or so in bank credit expansion over the next twelve months.

The effects of this more expansive policy would show up initially in interest rates on short-term securities. Our estimate is that 3-month bill rates would initially be reduced by 30 to 50 basis points as a result of the higher growth rate of the monetary aggregates--to a range around 6-1/2 per cent. Long-term rates would also be pulled down some, but by a smaller amount.

However, as monetary growth rates slowed again in 1971, and as the effects of more rapid monetary expansion began to be registered in higher levels of GNP and increased transactions demand for money, bill yields would probably return to about the same level as with the 4 per cent rate of monetary expansion.

Our estimate of the marginal effect of this small change in policy on total demands for goods and services is, of course, quite uncertain. We have been guided by simulations of our econometric model, as well as by our judgmental procedures. As best we can judge, the effects of the more expansive policy on GNP growth would become perceptible toward the close of 1970 and in early 1971. In the first half of next year, we might be seeing gains in nominal GNP \$3 billion or so larger--with increases in spending spread widely among the major categories of private spending.

Associated with these larger gains in nominal GNP, we believe, would be a pickup in real growth to about a 4 per cent rate in the first half of next year. This would be close to our long-range growth potential. But since productivity gains would also be stimulated by the

faster pace of recovery, and unused resources would be in ample supply, the slightly faster pace of economic expansion would still permit substantial progress during the next year in getting costs and prices under better control.

Indeed, if we have estimated correctly the pickup in the tempo of real growth consistent with the more expansive monetary policy, the improvement in the unemployment picture probably would be relatively small. Productivity gains would accelerate, and the labor force would increase somewhat more rapidly, as additional job opportunities encouraged rising participation rates. As a rough estimate, the unemployment rate in the second quarter of next year might average 5.8 per cent instead of 6 per cent.

While the increase in aggregate demand accompanying the more expansive policy would exert some additional upward pull on prices, we believe the effect would be small--and that the rate of increase in the GNP deflator would still recede to about 3 per cent by the second quarter of next year. This view hinges on the belief that the additional productivity gains would be large enough to offset nearly all of the larger increases that might occur in compensation per manhour, so that unit labor costs would be affected relatively little.

The short-run financial implications of the two courses of policy we have been discussing are considered in the blue book^{1/} in connection with directive alternatives B and C. Alternative B is in the spirit of the less expansive course of policy that underlies our formal GNP projection--calling, as it does, for a 4 per cent growth rate of the money supply and a 5-1/2 per cent rate of rise in the adjusted credit proxy in the third quarter. Alternative C sets the third quarter targets for policy at 6 per cent for the money supply and 7-1/2 per cent for the adjusted proxy--which would put us on track with the more expansive course of policy.

The money market conditions associated with these alternative growth paths for the aggregates are difficult

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

to pinpoint with any degree of accuracy. The figures in the blue book are the staff's best estimates of the patterns that would develop between now and the next meeting of the Committee, and they are broadly consistent with the longer-run relations that were worked out in our GNP and flow-of-funds projection.

Given the uncertainties still persisting in financial markets, however, the Committee may desire to continue for a while giving primary emphasis to money market conditions, and to renew the previous directive. The specifications for alternative A, as discussed in the blue book, interpret maintenance of prevailing money market conditions as implying a Federal funds rate in the 7-5/8 to 8 per cent range, and associate with it a relatively wide range for net borrowed reserves--reflecting the difficulty of being very precise in a period when the uncertainties are as great as they are now. If these money market conditions were maintained, we would expect growth in the money supply at roughly a 5 per cent rate in the third quarter, while the credit proxy would be projected at about a 6-1/2 per cent growth rate.

In this construction of the directive, of course, it is the behavior of the aggregates that is more uncertain. But if the Committee should wish to continue emphasizing money market conditions, while at the same time encouraging somewhat faster growth in the aggregates, it could adopt directive language with the money market emphasis of A, but with the money market conditions specified in C. In view of the possible financial strains that could develop in the weeks ahead, this is the course of action that I, personally, would recommend to the Committee.

Chairman Burns said he thought the staff's presentation had been excellent. He then called for a general discussion of the economic and financial situation.

Mr. Heflin remarked that the Committee faced three key issues today. The most pressing of the immediate issues was the question of the current state of financial markets. The near-crisis conditions prevailing at the time of the Committee's last meeting had forced it to depart temporarily from the objectives of its May 5 directive and to give first priority to market conditions. It was necessary to decide

6/23/70

-23-

whether those near-crisis conditions had been sufficiently allayed to allow the Committee to move back to the course laid out in its May 5 directive.

Secondly, Mr. Heflin observed, the Committee had to face up to the question of whether inflationary expectations continued to play a key role in determining market psychology. Finally, as a longer-run matter, there was the question of how much more of an updrift in the unemployment rate was acceptable. There could be little doubt that the rate would move up to 5-1/2 per cent, and the green book projections suggested that it could be close to 6 per cent by the end of the year. Unemployment of that magnitude, coupled with price rises of even 3-1/2 per cent to 4 per cent per year, would very likely create social and political pressures that might well make it impossible for the Committee to stick to any path of moderate expansion. It seemed to him that that situation contained the makings of a real dilemma.

Mr. Francis remarked that the slowdown of the economy since late last summer continued very moderate compared with those that had been necessary in correction of past inflations. Payroll employment had risen slightly since late last year, and apparently a tight labor market, conducive to large wage increases, continued. Civilian employment relative to population of working force age was higher than at any time from 1950 through 1967. Retail sales had

6/23/70

-24-

grown as fast since last fall as in the previous year. Personal income had grown at a 7 per cent annual rate.

To his mind, Mr. Francis said, those developments reinforced the need to permit only moderate money growth for the foreseeable future. The exceedingly high monetary growth of the past three months had been regrettable, but not catastrophic. It would have some effect in delaying significant deceleration of inflation, but if the Committee could now get back on a course of only moderate monetary growth the loss would not have been great.

Mr. Francis hoped the Committee did not operate on an assumption that a rapid rate of monetary expansion at present would alter the course of economic activity appreciably for the next few months. Monetary growth generally operated upon total spending and real production with a considerable lag. Rapid monetary expansion now would most likely affect real product in early 1971 and be responsible for an inflationary surge and higher interest rates a year from now.

It seemed to Mr. Francis that recent financial strains had not been greater than markets could take in stride. Short-term interest rates since the beginning of the year, unlike developments in periods of money panic, had declined. Short-term rates were generally lower now than they had been on average from last June to February. While bond and stock yields had risen, he felt that

6/23/70

-25-

those developments neither reflected a money crisis nor were an indication of great monetary restraint. Most of the price adjustments in those markets probably reflected rising expectations of inflation, reinforced by the Cambodian invasion, revisions in the Federal budget, the continued rapid price rises, and the large injection of money since February.

Mr. Francis commented that some rationalization had been given for the recent rapid growth of money on grounds that the demand for money to hold might have risen. But he knew of no persuasive evidence of such a development. Since 1965 increases in the demand for money had repeatedly been offered as a rationalization for the periods of excessive growth in the supply of money that had brought the economy to its present inflationary position.

Mr. Mitchell said that Mr. Francis' remarks about rapid rates of monetary growth reminded him of comments made by Professor Milton Friedman at the Board's meeting with its academic consultants on the preceding Friday. Professor Friedman had indicated that the recent annual rate of growth of money was about 9 per cent--a figure which had been used repeatedly of late in publications of the St. Louis Federal Reserve Bank and which might well be described as high. But, as he (Mr. Mitchell) had noted at the meeting on Friday, data prepared by the Board's staff indicated that the recent growth rate of money was about 4 per cent--a pace that both Professor Friedman and Mr. Francis would no doubt consider moderate.

The difference, of course, reflected differences in the time periods used, Mr. Mitchell observed. The 9 per cent figure represented the change from the February level to that of May. The Board's staff had followed its customary practice of measuring changes between the final months of calendar quarters, and had found the growth rates to be 3.8 per cent over the first quarter and 4.5 per cent over the second. The results differed so markedly in part because of the recent very wide month-to-month fluctuations in the money supply, some of which reflected statistical aberrations.

In his judgment, Mr. Mitchell continued, the Federal Reserve was doing itself a disservice by simultaneously publicizing such disparate descriptions of "recent" rates of growth in money. The issue could legitimately be described as a question of fact, and it was one that the System should be able to settle internally. It was his personal view that the approach being followed by the St. Louis Reserve Bank was creating the mistaken impression that the System had not been doing a good job in making monetary policy.

In the ensuing discussion Messrs. Daane and Brimmer both indicated that on their recent trips to Europe they had found that the 9 per cent figure for the growth rate of money had been widely reported and was causing a good deal of confusion. Mr. Daane added that the publicity given to the St. Louis position had opened a credibility gap abroad that might be difficult to close.

Mr. Hickman noted that he had found a similar credibility gap among the directors of his Bank, who were disturbed to read in the newspapers that money was expanding at a 9 per cent rate after being told by his staff that it was growing moderately. In his judgment the existing situation complicated the Committee's task of policy-making, and should be resolved by arriving at some mutually acceptable basis for measuring money supply changes.

Chairman Burns commented that the omission from the St. Louis calculation of the projection for June--when a slight decline in money was anticipated--explained part of the difference in figures that Mr. Mitchell had described. It was clear that there was no one "right" basis for such calculations; economists were free to choose whatever dates they thought best suited their particular purposes. At the same time, it should be possible for the Federal Reserve to avoid excessive variety in the measurement methods it employed. Perhaps a staff committee drawn from the Board and the Reserve Banks might be asked to look into the matter, to see whether some agreement might be reached that would serve for the time being.

Mr. Brimmer suggested that an appropriate group for that purpose would consist of the Committee's Economist and Associate Economists. He then expressed the view that the problem went beyond that of differences in methods of measuring changes in the money supply. The St. Louis Bank now employed an approach to analysis that was competitive with that used elsewhere in the System; some

6/23/70

-28-

day there might be thirteen different analytical approaches in the System, with the Board and each Bank going its own way. While he would not favor censorship, he thought the staff committee should be asked to consider questions of analysis as well as of measurement.

Mr. Mitchell said he would disassociate himself from Mr. Brimmer's position. A part of the character of the Federal Reserve that he would want to preserve was its ability to accommodate differences of view and philosophy, and he favored encouraging System people to use whatever analytical techniques they chose.

Mr. Francis remarked that it certainly had not been the intention of the St. Louis Bank to publish misleading figures. The 9 per cent growth rate had been calculated from money supply numbers compiled at the Board and by procedures that were similar to those his Bank had employed for a number of years. Like others, however, he was disturbed by the confusion that had resulted from the publication of different measures of the recent change in money, and he was very much in favor of an effort to reach agreement on an appropriate base period for calculating the change. Indeed, he had prepared remarks on that subject for use in today's discussion which he would submit for inclusion in the record.^{1/}

Chairman Burns commented that the Committee's frank discussion had been highly useful. Personally, his only criticism of the

^{1/} Mr. Francis' submission on this subject is appended to this memorandum as Attachment E.

St. Louis Bank people in the matter related to what he thought was an element of rigidity in their thinking about base periods; they had an unfortunate tendency to consider changes measured from certain dates as true and all others as false. If there were no objections, he would ask the Committee's Economist and Associate Economists to consider the question of measurement procedures.

There were no objections to the Chairman's proposal.

Mr. Maisel said he shared Chairman Burns' view that the St. Louis Bank tended to stress unduly the "correctness" of moving four-week periods as a measurement base. Over time some of those arbitrary bases led to most peculiar analytical results. He also agreed with Mr. Mitchell that nothing should be done to interfere with free competition within the System among monetary theories. As the directive committee had emphasized in its recent report to the Open Market Committee, it was both possible and necessary for the Committee to formulate policy directives in such a way that differences in the preferences of members as to monetary theory and strategy could be accommodated in a single directive.

Turning to the question of the economic outlook and current monetary policy, Mr. Maisel said he thought the staff had done an excellent job in its presentation today in describing the alternatives facing the Committee. However, he suspected that in the main projection--based on a 4 per cent rate of increase in money--the staff had overestimated the rise in unemployment and underestimated the rate of increase in the deflator. In any case, he thought the

6/23/70

-30-

Committee should not accept as its goal the 6 per cent growth rate in nominal GNP implied by the projection; rather, it should aim for growth in nominal GNP at a rate in the 7 to 8 per cent range.

In his judgment, Mr. Maisel continued, a lower growth rate would involve a loss of output and higher unemployment without commensurate gains in terms of slowing the rate of price advance. Moreover, if the rate of growth in nominal GNP was increased to the 7 to 8 per cent range by means of monetary policy the additional spending would tend to occur in areas in which it was particularly needed--housing, State and local government expenditures, and business fixed investment.

In reply to a question by Mr. Mitchell, Mr. Partee said the GNP growth rate Mr. Maisel favored was relatively close to that projected by the staff for the first half of 1971 under the alternative policy course involving a 6 per cent rate of expansion in money for a time.

Chairman Burns observed that Mr. Maisel had raised a fundamental point, but he (the Chairman) would formulate it differently. He would be inclined to say that, of the two projections the staff had made on the basis of alternative assumptions regarding policy, the higher projection yielded growth rates of production and levels of unemployment that were not as good as those the nation should aspire to. He had cast that statement in terms of the nation's goals because instruments other than monetary policy might be brought to bear in striving toward it.

Mr. Maisel said that at this point in the meeting he was discussing only the goals of economic policy in general. He wanted to stress that the nation would be better off if nominal GNP expanded at a rate of 7 to 8 per cent rather than at a lower rate, and he would indicate what monetary policy he thought was most likely to achieve that goal when the directive to be issued at this meeting was under consideration.

In response to the Chairman's request for comment, Mr. Partee said he might first offer a word about Mr. Maisel's view that the staff had underestimated the rise in the deflator in the projection presented today. It was true that the Board's staff, like most other analysts, had been underestimating the rate of increase in the deflator rather consistently for some time. That experience had been taken into account in preparing the new projections of the deflator, which reflected careful judgments based on the results of several different approaches. He believed the new projections were likely to prove to be about on track; in any case, he knew of no other responsible projections that suggested a more rapid advance in prices, given the projected rate of advance in real GNP.

Mr. Partee then said the staff agreed with Mr. Maisel's comment that the Committee should not accept as its goal the behavior of GNP projected on the assumption that money would grow at a 4 per cent rate. That growth rate for money had been assumed for projection purposes because the Committee had been employing such a rate as a target for policy over the past several months, and

the staff thought it would have been unreasonable not to consider the probable consequences of holding to the same policy.

It was because those consequences appeared quite inadequate, Mr. Partee continued, that the staff had made an alternative projection based on the assumption of 6 per cent growth in money for a time. He should note that in the present state of the art it was difficult to estimate the effects of so small a change in policy assumptions. In any case, the results suggested that there would be relatively little effect in calendar 1970; but that in the first half of 1971 the rate of growth of real GNP would rise to about 4 per cent, the unemployment rate would increase a little less than otherwise, and the deflator would advance a bit more.

Mr. Partee noted that the staff had also explored the implications of more rapid growth in money--at annual rates of 8 per cent in the second half of 1970 and 6 per cent in the first half of 1971. The results included growth of real GNP at about a 5 per cent annual rate in the first and second quarters of 1971; a decline in the unemployment rate to 5.5 per cent in the first quarter and 5.4 per cent in the second; and a somewhat smaller decline in the rate of advance of the deflator--to 3.3 per cent by the second quarter.

Mr. Daane said he was troubled by the implications of fine-tuning involved in an effort to relate small differences in the rate of money growth to levels of unemployment. Not much was gained, he thought, by debating the relative merits of 4 or 6 per cent growth rates of money on the basis of GNP projections that could prove

6/23/70

-33-

wide of the mark; it would be more useful to attempt to sort out the three interrelated problems facing the Committee that Mr. Heflin had described. As to the level of unemployment and the general economic situation, he shared the view expressed by one of the economic consultants at their meeting with the Board on Friday that the present downswing involved something more serious than an inventory adjustment. The existing strains in financial markets were greater than any in his experience. At the same time, cost-push inflation and inflationary expectations were persisting.

Chairman Burns remarked that the staff's analysis seemed to suggest that the unemployment rate would remain undesirably high no matter what the posture of monetary policy. Perhaps the picture would have been different if alternatives with respect to other policy instruments had also been considered--although it was, of course, appropriate for the Federal Reserve staff to focus on monetary policy.

Mr. Partee commented that the projections were of the standard judgmental type, reflecting the staff's estimates of the most probable outcomes given the particular policy assumptions made. Since the staff thought the risks of shortfalls were much greater than those of overruns, in one sense the projections might be described as the best that could be hoped for, given the policy assumptions made. The rates of growth of money used to describe the different policy assumptions might be taken as proxies for

broader descriptions of alternative monetary policy courses, since each pattern of money supply growth had specific implications for expansion rates in other monetary aggregates and for interest rates.

Mr. Gramley remarked that the choice between fiscal and monetary policy for stimulating the economy clearly would have significant implications for the distribution of production gains among sectors of the economy, but it would have little impact on the distribution of any increase in nominal GNP between the growth in real activity and the increase in prices. The interesting conclusion from recent staff analysis was that, if either monetary or fiscal policy were successful in reversing the current downtrend, gains in productivity would accelerate and would spread from manufacturing to other sectors. One implication was that more stimulative measures could be undertaken now without significant sacrifice of progress in getting inflation under control. Another implication, however, was that the unemployment rate would remain relatively high for some time.

Mr. Eastburn noted that Mr. Partee had commented on the types of developments that might result in shortfalls from the projections. He inquired as to which sectors were considered by the staff as most likely to produce a significant error in the other direction.

Mr. Partee replied that the most likely source of such an error probably would be a sudden change in consumer attitudes. On

6/23/70

-35-

balance, he did not expect attitudes to improve in the near future, given the expected stream of bad business news. It was possible, however, that some major development--such as an end to the fighting in Indochina--might lead to a turn to much greater optimism on the part of consumers, and thus to a substantially higher level of consumption expenditures. He noted specifically, in response to a further question by Mr. Eastburn, that he did not think Federal spending would rise enough above projected levels in the year ahead to have a significant impact on aggregate outlays.

Mr. Brimmer noted that the staff's discussion of possible targets for the monetary aggregates in the blue book and in today's chart presentation had been prepared before the Board's action this morning on Regulation Q. He asked whether Mr. Partee would comment, either now or later in the meeting, on the effects the Board's action might have on the outlook for the aggregates.

Chairman Burns remarked that Mr. Partee might be able to give a more informed response to the question if he had additional time for thought and for consultation with his colleagues. Mr. Partee concurred in the Chairman's observation.

Mr. Hickman remarked that the present seemed to be a poor time to make a major change in the target growth rates for the monetary aggregates; it would be better to wait until the outlook was clearer. Economic data were quite weak for May, when the

6/23/70

-36-

general sluggishness in business activity was severely aggravated by strikes, particularly in the Midwest. However, there were indications of strengthening in production and employment in the Fourth District in early June. Perhaps partly for that reason, the projections of GNP and unemployment developed by his staff were more optimistic than those prepared at the Board.

Chairman Burns asked whether any others present had evidence that might tend to support the view that production and employment were strengthening in early June.

Mr. Partee remarked that the only such evidence of which he was aware was a further decline in initial claims for unemployment insurance. However, that probably was a consequence of the tapering off of the truckers' strike.

Chairman Burns observed that Mr. Hickman's comment was the first of its kind that he had heard. He hoped that people at the other Reserve Banks would advise the Board immediately if information of a similar sort became available in their Districts.

Mr. Baughman expressed the view that consumer attitudes were being influenced significantly by the possibility of interruptions of employment and income as a result of strikes. If some more or less standard settlement in wage negotiations should emerge, as had been the case at times in the past, the resulting reduction in the risk of strikes might have an impact on spending patterns.

6/23/70

-37-

In general, Mr. Baughman continued, strikes were having a considerable influence on activity in the Chicago area. The local truckers' strike was continuing and did not appear likely to end soon. Other work stoppages involved carpenters, cement finishers, and operators of heavy construction equipment. The secondary effects of those labor disputes were widespread and were appearing in various forms, such as shortened workweeks at large retailers.

Mr. Baughman added that the latest data on production and sales of automobiles might be interpreted as lending a shade of support to Mr. Hickman's views about an upturn in June, although they were not as strong as industry analysts had anticipated. Business economists with whom the Chicago Bank consulted did not think there was much of a problem of excessive inventories. On the whole, however, the general outlook portrayed in the staff's projection struck him as quite realistic.

Mr. Swan said he was concerned about the staff's view that a more rapid rate of monetary expansion would have little effect on the deflator. The rate of price advance had been underestimated in the past and he suspected that the same thing was happening again, even granting Mr. Gramley's argument about increases in productivity. Although a beginning might have been made, the task of dampening inflationary expectations certainly had not been accomplished as yet; and such expectations could easily be rekindled.

6/23/70

-38-

Mr. Swan then noted that in its alternative projection the staff assumed a 6 per cent growth rate in money during the second half of 1970 followed by a gradual return to a 4 per cent rate by mid-1971. He was puzzled by the choice of that particular pattern. If the staff believed that 4 per cent growth was inadequate, why had it not assumed a steady 6 per cent rate for its alternative projection?

Mr. Partee replied that the need appeared to be for only temporary stimulation, taking account of expected lags in the effects of monetary policy changes. Of course, if the Committee were to adopt the alternative policy and seek a 6 per cent growth rate in money, it would have an opportunity to reassess the situation before letting the growth rate begin to fall back toward 4 per cent.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period May 26 through June 17, 1970, and a supplemental report covering the period June 18 through 22, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said there had been no significant reaction in the exchange markets to the Penn Central affair, although some stiffening had occurred in Euro-dollar rates.

6/23/70

-39-

Mr. Coombs then recalled that at earlier Committee meetings Mr. Bodner and he had noted that the exchange markets were still suspending judgment as to which currencies would fare better or worse in the battle against inflation, with the result that trading remained remarkably quiet and orderly. Few people had had any illusions that such a precarious balance would last very long, and it had not. In May the Canadian dollar became subject to speculative buying pressure which resulted in the surprising decision to let the Canadian dollar float upward. So far in June the German Federal Bank had been forced to take in more than \$900 million spot and nearly \$300 million forward, largely reflecting speculation engendered by the Canadian move. The Swiss franc, the Belgian franc, and the Dutch guilder had also strengthened with a revival of speculative talk of their eventual revaluation. Conversely, sterling and the lira had weakened while the French franc had lost much of its earlier strength. Finally, and most disturbing of all, participants in the European markets were busily persuading themselves that the dollar had become overvalued and were accusing the U.S. Government of actively promoting revaluations of other major currencies so as to restore its competitive position. The U.S. balance of payments figures for the second quarter seemed likely to breed further speculative talk against the dollar.

In general, Mr. Coombs added, the atmosphere had deteriorated with growing tension between the United States and Europe on financial

6/23/70

-40-

policy approaches. European moves toward financial integration designed to provide protection against the dollar were flashing a warning signal.

Nevertheless, Mr. Coombs continued, he suspected that the main trouble spots over coming months would be the lira and sterling; before the year was out there might well be heavy use of System lines by the two central banks involved. After paying down their swap debt to the Federal Reserve from \$800 million to \$200 million, the Bank of Italy now had had to make two new drawings of \$100 million each in dealing with reserve losses of \$250 million so far this month. However, the Bank of Italy was now beginning to mobilize some of its unused claims on the International Monetary Fund, and he would hope that part of the proceeds would be devoted to paying off debt under the swap line. More generally, he thought the Bank of Italy would soon have to face up to the question of whether tourist spending during the summer months would suffice not only to halt recent reserve drains but also to liquidate their swap debt. If not, he thought they would be well advised to go to the Fund or to other creditors for a drawing big enough to clean up the swap line in anticipation of possibly heavy needs for new swap credits during the fall and winter months.

In the case of sterling, Mr. Coombs observed, the election of the new Conservative Government had resulted in British reserve gains of more than \$100 million on the next day, but subsequently sterling slipped back into the weakening trend that had become

6/23/70

-41-

evident a month or so ago. Inflationary wage settlements and a deteriorating trade balance in the United Kingdom had revived market suspicions of sterling, with the rate declining further to \$2.3955 this morning. On the other hand, the dollar guarantee provided by the British Government on Sterling Area central bank balances might restrain any massive cashing in of sterling balances such as occurred in earlier crisis periods, and so lessen British recourse to the swap line.

Over coming months, Mr. Coombs said, there probably would be heavy flows of funds from time to time to Germany, Switzerland, and certain other European countries. In such circumstances, he thought that the System should not hesitate to draw on the swap lines to the extent requested by any of the foreign central banks concerned, and that it also should engage in forward operations designed to reverse the flow of hot money whenever that appeared desirable. None of the European currencies now favored by speculation was clearly undervalued, nor was there any present reason to believe that over the next year or so the United States would inevitably suffer a more severe degree of inflation than the Canadians, Germans, Swiss, Dutch, and Belgians.

The main risk on the international currency scene that Mr. Coombs saw at the moment was, rather, that the presumption hitherto of exchange rate stability and vigorous official defense of

6/23/70

-42-

parities subjected to speculative pressure might become increasingly suspect. Until the Canadian decision to let their rate float, the market had not taken seriously official discussions of rate flexibility. Although most of the European central banks had asserted that they had no intention of following the Canadian example, the market had been left with a strong suspicion that new surprises of the Canadian variety might well be in the offing. New speculative storms might therefore blow up more suddenly and with far greater intensity than any seen before. However, the System had available the means of dealing with those speculative storms, and it should not back away from using them as forcefully as it had in the past. In effect, it should play the game as if it intended and expected to win.

Mr. Heflin asked whether there had been any express or implied agreement at the time of the decision to create Special Drawing Rights about the use of SDR's for balance of payments purposes. He noted that at the recent annual convention of the District of Columbia Bankers Association a leading Swiss banker had charged, in effect, that the United States had violated its word in that regard.

Mr. Solomon noted that the United States had not in fact been a net user of SDR's; there had been a net increase in U.S. holdings since SDR's were first created.

Mr. Daane added that SDR's had always been intended as reserve assets usable in the same way as other such assets whenever

6/23/70

-43-

there was a balance of payments need. There had been some suspicion during the negotiations on SDR's that the United States wanted them created in order to solve its balance of payments problem, but the U S representatives had always argued that they were needed to provide for the required secular growth in world reserves. In any case, no restrictions other than balance of payments needs had been placed on their use apart from certain technical restrictions regarding reconstitution which were irrelevant to this discussion.

Mr. Coombs suggested that comments such as that of the Swiss banker might reflect a feeling of disappointment that the United States was still running a deficit in its balance of payments, so that international liquidity was rising as a result not only of the creation of SDR's but also because of the outflow of dollars.

Mr. Brimmer noted that some people with whom he had talked at the recent BIS meeting apparently had had the impression that SDR's would be used as a substitute for dollars rather than as an addition to them.

By unanimous vote, the System open market transactions in foreign currencies during the period May 26 through June 22, 1970, were approved, ratified and confirmed.

Mr. Coombs then observed that a drawing by the Bank of Italy, in the amount of \$200 million, would mature for the second time on July 23, 1970. He would recommend renewal if requested by the Bank of Italy, although he was hopeful that the Italians

6/23/70

-44-

would succeed in their current effort to mobilize credit elsewhere to repay the drawing before maturity. Even if more time were needed to clean up the loan in an orderly fashion, he was confident it would be paid off by late summer or early fall.

Renewal of the \$200 million drawing by the Bank of Italy was noted without objection.

The Chairman then invited Messrs. Brimmer and Daane to comment on their recent trips to Europe.

Mr. Brimmer reported that during the first week of June he had been in Germany, visiting the German Federal Bank in Frankfurt, German Government Ministries, and U.S. Embassy officials in Bonn. At the Federal Bank he had had the great and--he was told--unprecedented privilege of meeting with their Council. That group is made up of board members plus the heads of the regional banks and is a counterpart to the Open Market Committee, although it also deals with administrative matters. The Council had rearranged its agenda so as to discuss international matters in the morning and had invited him in at noon for an hour's discussion.

The major focus of that discussion, Mr. Brimmer reported, had been the present condition and outlook for the U.S. economy and, more specifically, the strength of the commitment of U.S. authorities to carry on the fight against inflation. Other topics discussed included the incipient flows of funds into Germany and the uncertainties created by the Canadian decision to allow its exchange rate to

6/23/70

-45-

float. Stories had appeared in the German newspapers to the effect that he had come to Germany to exert pressure for another revaluation of the mark. While those stories were, of course, unfounded, they were an indication of the current sensitivity of German financial markets and public opinion.

Mr. Brimmer commented that his talks with the principal Government Ministers in Bonn had been limited by lack of time and by the fact that the Ministers were engaged in the parliamentary debate on the Government budget. The key Ministers, however, had arranged for him to talk with their principal deputies. Those talks had involved assessments of the economic situation in both Germany and the United States. As at the Federal Bank, the commitment of the United States to the fight against inflation had been questioned.

Mr. Brimmer noted that the main purpose of his trip to Europe had been to attend the meeting of the BIS in Basle during the weekend of June 6 to 8. One interesting development during the discussion at the Sunday afternoon session was the effort by some Europeans to show that the problems facing Canada had their origins in the United States. The matter of Investors Overseas Services (IOS) had also been discussed; it was obvious that the various governors knew little about the activities of IOS in their respective countries. He had suggested that efforts be made to keep abreast of the situation and to pool information when anything

6/23/70

-46-

of special interest developed. That view was shared by others, but it was agreed that no formal action need be taken at this time.

Discussions in the corridors outside the formal meetings had also focused on the strength of the dollar and the determination of the United States to fight inflation, Mr. Brimmer said. As he had already noted, there had been comments to the effect that SDR's had been intended as substitutes for rather than supplements to dollars; it was suggested that SDR's had been created on the assumption that the U.S. balance of payments would over time be brought closer to equilibrium, with a resulting need for a new source of international reserves.

Mr. Daane noted that he had attended the meeting of the Economic Policy Committee of the Organization for Economic Cooperation and Development in Paris on June 15 and 16. The U.S. delegation, of which he was a member, had been headed by Dr. McCracken, Chairman of the Council of Economic Advisers. There had been a general exchange of views about economic trends and prospects for the next twelve months, but the central focus of the meeting had been on how to win the battles against inflation going on in the various countries.

It was his impression, Mr. Daane continued, that there was a general feeling of frustration and discouragement among the representatives over the difficulties of coping with the kind of inflations now being experienced in their countries as well as in the United States. Most had accepted the view that in the United

6/23/70

-47-

States demand management was sufficient for the present, but they probed as to whether something more could be done in the general area of incomes policy. The meeting had taken place prior to President Nixon's June 17 speech on the economy, but Dr. McCracken had hinted that the President planned to touch on the subject of incomes policy.

Mr. Van Lennep, Secretary-General of the OECD, was elected Chairman of the EPC for the coming year, Mr. Daane said. He (Mr. Van Lennep) was very concerned about the inflation problem and had proposed a crash program to include: (1) a quick report by experts; (2) an early meeting of the EPC to discuss the report; and (3) an early subsequent meeting of the Finance Ministers of the respective countries to coordinate actions against inflation. The EPC, while sharing his concern about inflation, had not accepted his proposal. Instead, it had asked him to prepare a report for its next meeting, to be held in November, on possible means to supplement demand management--perhaps including manpower policies, regional policies, sectoral policies, incomes policies, and encouragement of national and international competition. That assignment had been made despite considerable skepticism on the part of some as to whether such supplementary policies could be effective.

Mr. Daane said that the Canadian situation had also been discussed. Some of those present had been highly critical of the Canadian decision to let their currency float, suggesting that it

6/23/70

-48-

had violated the Fund's Articles of Agreement. However, others-- including the Germans--had been more sympathetic.

In conversations outside the formal meeting, Mr. Daane remarked, he had found confidence in the dollar at a low ebb for a variety of reasons, chiefly involving possible forthcoming flows of dollars. The view had been expressed by some that the United States was promoting a series of revaluations elsewhere in order to improve the relative position of its own currency. That suggestion had been flatly denied by Under Secretary Volcker. He had argued that such revaluations, if they engendered continuing uncertainty about the value of the dollar, clearly would not be in the long-run interests of the United States. Also, the U.S. role in the Canadian move to a floating rate had been questioned. He hoped that the U.S. delegation had convinced the questioners that there had been no consultations with the Canadians prior to their decision and that the United States would view general adoption of floating rates as the worst of all possible worlds.

Mr. Daane added that the questions being raised with regard to SDR's might reflect an idea expressed by the President of the BIS in his annual report to the effect that, in the current situation of widespread inflation, SDR's were not as welcome as they had been earlier.

Mr. Coombs said that he understood the report had gone even further and had questioned whether the logic of SDR's was

6/23/70

-49-

sustainable, given the continuing large deficit in the U.S. balance of payments.

Mr. Solomon concurred in Mr. Coombs' comment. He added that the assumptions underlying the creation of SDR's had been, first, that if the U.S. balance of payments deficit was reduced as sharply as was hoped, a major source of international reserves would dry up; and, secondly, that if the United States was to succeed in reducing its deficit a supplementary source of reserves would be needed because other countries wanted to continue to add to reserves. On that basis, he thought the Europeans had every right to complain about the continuation of large U.S. deficits. On the other hand, only six months had elapsed since the first SDR's had been created. If the U.S. balance of payments improved sharply in the next year he felt sure there would be no serious complaints. It should be remembered that when the amount of SDR's to be created in the first three years had been decided upon it had been realized that they alone would not be sufficient. A small deficit--for example, \$1 billion to \$2 billion--in the U.S. balance of payments on the official settlements basis was therefore viewed as tolerable, but one of \$5 billion to \$6 billion was not.

Chairman Burns said it was obvious that there was some nervousness abroad about the position of the dollar and the very large deficit in the U.S. balance of payments.

6/23/70

-50-

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 May 26 through June 17, 1970, and a supplemental report covering the period June 18 through 22, 1970. Copies of both reports have been placed in the files of the Committee.

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

Financial markets lost some of the near-panic atmosphere over the period since the Committee last met, but an uneasy and nervous undertone still remains. There is still considerable worry over the situations in the Mid-East and in Southeast Asia, and, despite additional signs of a weakening economy, a great concern about inflation--a concern that has been intensified by recent reports of a rapid rise in the money supply. The Chairman's statement at the White House meeting just after the last meeting of the Committee, that the System was alert to avoid a liquidity crisis, gave the markets a boost; and the announcement of President Nixon's economic address provided another boost later on. Continued heavy corporate demand for funds, however, has kept the capital markets under pressure, and the failure of efforts to rescue the Penn Central railroad from insolvency leaves some serious problems for the commercial paper market. Yesterday the company was unable to pay off \$1.7 million of maturing notes. Altogether there is about \$80 million of paper still outstanding, with maturities stretching out to December, held by a wide assortment of institutional and other investors. This development is bound to intensify the existing trend towards increased investor concern over credit risks in the paper market, and it is quite apparent that a growing number of issuers will find it increasingly difficult to roll over maturities, let alone add to outstanding volume. Obviously, there will be increased credit demands on the banking system and some firms that are not doing well financially may find it impossible to meet their credit needs.

It is not clear at this moment how much of the \$33 billion of nonbank commercial and financial paper outstanding is vulnerable, nor is it clear how orderly the shift of credit back to the banking system can be. In the absence of any change in regulation, banks would have had to rely on some switching by investors from nonbank paper into bank-related commercial paper, and on the Federal funds and Euro-dollar markets. The Board's action on Regulation Q certainly opens new vistas for the banks, and one would expect a rapid expansion in short-term CD's. Actually, the rechanneling of credit back into the commercial banking system is basically a healthy development, if panic-like side developments can be avoided in the process of adjustment.

Increased investor emphasis on quality and liquidity should generally be favorable for the Government security market, particularly for Treasury bills. This certainly proved to be the case yesterday. On the other hand, one cannot be sure how much the problems of the commercial paper market, together with bank competition for CD money, will force the general level of short-term rates higher. And if, in addition, banks come under substantial loan pressure, the Treasury may be faced with underwriting problems as it tries to raise \$5 billion to \$6 billion cash in the bill market in the next month or so. Fortunately, the market is in an excellent technical position, partly reflecting substantial purchases by the System. Dealer bill positions as of June 19--at about \$900 million--were only about one-fifth of their mid-April peak, with net System purchases accounting for about one-third of the decline. Holdings of coupon issues--at about \$450 million--were down by about two-thirds from their peak after the May refunding, with System and Treasury purchases accounting for about four-fifths of the decline. Yesterday's bill auction was quite strong, with average rates of 6.63 and 6.93 per cent established for three- and six-month bills, respectively, down 50 and 43 basis points from levels established in the auction just preceding the last meeting of the Committee.

System open market operations since the last meeting were directed towards maintaining a comfortable money market and helping to restore a measure of stability to financial markets. A large volume of operations was involved in this effort, including gross purchases in the market of over \$1 billion of Treasury bills and \$305 million

of coupon issues, and the arrangement of \$1.2 billion of repurchase agreements. Foreign accounts were, fortunately, substantial net buyers of bills on balance, and we were able to integrate these operations with System transactions. In order to partially offset the reserve impact of these purchases, we followed the practice of bidding to run off a portion of maturing bills held in the System portfolio in the regular Treasury bill auctions--a practice for which the market implications are less adverse than they would be for an equivalent amount of outright sales. Net borrowed reserves fluctuated widely over the period, ranging from over \$1 billion in the week ended June 3--when banks acquired an unusually large volume of reserves by borrowing at the discount window despite a very comfortable Federal funds market--to \$418 million last week when float bulged unexpectedly on the final two days. We were generally successful in keeping the Federal funds rate at 8 per cent or below, and have permitted a touch more ease to develop in the past few days while awaiting the results of the Penn Central negotiations and their aftermath.

Although our main attention was focused on the markets, the money supply, rather unaccountably, appears to be turning out much closer to the Committee's earlier target path than seemed at all likely at the time of the last meeting. The money supply grew at a 4.1 per cent annual rate in May, less than half of the 9.5 per cent rate projected at the time of the last meeting. And if the blue book's June projection turns out to be correct, the growth rate for the second quarter will be about 4-1/2 per cent, and for the first six months of the year just a touch over 4 per cent. Publication of such numbers--or something close to them--will, I believe, be taken quite constructively by the market. As you know, a number of market participants and economists have been quite concerned about the February to May money supply rise of 9-1/2 per cent, which has been interpreted by many as a sign that the Federal Reserve has pushed too far towards monetary ease.

Looking to the period ahead, it appears likely that the System may have to provide about \$1 billion in reserves over the next two weeks to meet a seasonal rise in currency in circulation and an increase in required reserves. This demand, together with other seasonal demands for Treasury bills, would normally tend to exert considerable downward pressure on Treasury bill and other short-term rates. But the uncertain situation in the commercial paper market and the change in Regulation Q, together with the imminent Treasury financing, cast a cloud on the likely behavior of rates in the weeks ahead. And if the dollar comes under pressure in the exchange markets, another area of uncertainty will be introduced.

The commercial paper situation and the change in Q also cast a shadow on the blue book projections of the aggregates in the months ahead, particularly with respect to the adjusted credit proxy, as the supplementary notes on the draft directives indicate. As you know, on the assumption of no change in money market conditions--alternative A of the directive--the blue book projects a 5 per cent annual rate of growth in money supply and a 6-1/2 per cent growth rate in the proxy over the third quarter. New York projections are quite similar for the quarter as a whole, although there is a substantial difference in the monthly pattern. I would assume that the Committee would want to accommodate an increase in required reserves emerging from a switch out of the commercial paper market into the banks. There will remain a question of how the Committee might regard a substantial expansion of total credit if banks expand CD's very rapidly. If the Committee decides to adopt alternative A it would be very helpful to get the Committee's views on how strongly a rise in Treasury bill rates up into the upper end of the 6-1/2 to 7 per cent range should be resisted if it develops. Under certain adverse conditions a very sharp upward surge of short-term rates could conceivably develop which might be quite costly to resist in terms of reserve supply and eventual effect on the aggregates. As the blue book makes amply clear, alternatives B and C would focus primary attention on the aggregates. If the projections stand the test of time, alternative B would imply somewhat firmer, and alternative C somewhat easier, money market conditions than have recently prevailed.

In closing, it seems to me that the current situation in the commercial paper market casts a shadow over the immediate future that can only be resolved as developments unfold. The markets acted quite favorably yesterday, but that is only a single day's experience. Projections of the aggregates and of the outlook for interest rates are even less certain than usual. It is obvious that we will have to stay in even closer touch than usual with day-to-day developments and be prepared for the flexible use of open market operations and other policy instruments as the situation may require.

In reply to the Chairman's inquiry, Mr. Partee said he was now ready to respond to Mr. Brimmer's earlier question about the implications of the Board's Regulation Q action for the monetary

6/23/70

-54-

aggregates. He would note that it was extremely difficult to evaluate those implications, for several reasons. First, there had never been a change like the current one, in which interest rate ceilings were suspended entirely for CD's of some but not all maturities. Secondly, it was hard to predict the effect on bank attitudes of the element of temporariness in the action. Finally, the amount of unwinding that might occur in the commercial paper and capital markets over the next few months, and for which substitute bank financing would be needed, was highly uncertain at this point.

It seemed likely, Mr. Partee continued, that the main impact of the action would be on bank credit rather than on the money supply. Recognizing all of the uncertainties he had mentioned, it was the staff's best guess that total bank credit would rise during the third quarter by about \$2 billion more than specified in the blue book under each of the three alternative policy courses discussed there. That would be equivalent to the addition of about 2 percentage points to the annual rates of growth of the adjusted proxy indicated in the blue book for each of the alternatives. The expected third-quarter increment of \$2 billion might be distributed by months roughly as follows: \$750 million in July, \$750 million in August, and \$500 million in September. By type of earning asset, the increment would probably be mainly in the form of loans, as businesses substituted bank credit for commercial paper and capital market borrowings. However, some might also be reflected

6/23/70

-55-

in security holdings, if some banks decided to hold on to the Treasury's newly offered tax-anticipation bills a bit longer than they otherwise would have, and if some banks wanted to improve their liquidity positions a little more.

As to the effects on bank liabilities, Mr. Partee said, the staff would expect some substitution of CD's for funds from nondeposit sources--both Euro-dollars and bank-related commercial paper. The blue book analysis allowed for a slight increase in nondeposit funds during the third quarter under each of the three alternatives, but it was now thought that banks would reduce their reliance on such funds. Accordingly, the increment to time deposits over the quarter was expected to be somewhat greater than \$2 billion. In his judgment it was important that the System provide the reserves needed for the greater expansion of time deposits, to avoid the restrictive effect the action otherwise would have.

Mr. Partee observed that the Regulation Q action was expected to have little effect on prospective changes in the money supply because CD's were not regarded as significantly closer substitutes for money than was commercial paper. Nor was much effect on interest rates anticipated. There might be some small announcement effect, especially since the bill market was in a technically strong position and since rates had been drifting down recently. To allow for that possibility, the staff would now be inclined to lower the bottom of the bill rate ranges specified in the blue book for each

of the three policy alternatives by about 10 basis points. Over the longer run there might be some tendency for the action to raise short-term rates relative to long, if it induced banks to expand greatly the volume of 30 to 89 day CD's outstanding and to place some of the funds obtained in longer-term loans and investments. In view of the temporariness of the Board's action, however, he would not expect there to be much evidence of such an effect during the third quarter.

Mr. Daane asked how the Manager would assess the likely repercussions at this juncture of a Committee decision to shift to a somewhat easier posture. In particular, would there be much impact on expectations?

Mr. Holmes said he thought there was some risk of such an outcome, depending in part on how banks interpreted the Board's action on Regulation Q. If they thought the suspension of ceilings was likely to be quite temporary they might rapidly expand the volume of CD's outstanding and so place substantial upward pressures on short-term interest rates--pressures which might be difficult to overcome through open market operations.

In reply to a question by Mr. Brimmer, Mr. Holmes said he thought there might well be a rapid increase in CD's outstanding in the period before the next meeting of the Committee. Much of that expansion was likely to represent a substitution of CD's for commercial paper, although he would expect continued sales of bank-related commercial paper with maturities of less than 30 days. There probably would also be some substitution of CD's for Euro-dollars,

but the amount might be limited--especially if banks regarded the Q action as temporary.

Mr. Hickman noted that the blue book specifications for directive alternative C included a 9 per cent annual rate of growth for money in July. He asked what interpretation the market might place on such a figure, if it were realized.

Chairman Burns, observing that those specifications also included a decline at a rate of 1 per cent in June, suggested that observers might be inclined to base their impressions on the average growth rate in the two months.

Mr. Holmes agreed that observers were unlikely to place a great deal of weight on the growth of money in a single month, particularly soon after data on the growth rate over the first half of the year were made public. Whatever reaction there was to the July figure would no doubt be influenced by the nature of the economic situation at the time it was published.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period May 26 through June 22, 1970, were approved, ratified, and confirmed.

Chairman Burns then called for the go-around of comments and views on monetary policy, beginning with Mr. Treiber, who commented as follows:

Governor Daane referred to the concern expressed abroad about the dollar. A convincing and sustained attack on domestic inflation remains essential for improving our balance of payments and strengthening confidence in the dollar.

Financial markets are in a much less frantic mood than they were at the time of the last meeting. Yet there continue to be widespread fears of liquidity problems. The insolvency of the Penn Central Transportation Company may have set in motion substantial forces which have not yet manifested themselves. A vigorous reappraisal of commercial paper is now going on; it could result in high demands for bank credit and substantial pressures in financial markets, but the extent of such pressures is not yet clear.

The Government's budgetary outlook has been deteriorating. Fiscal policy is likely to be more stimulative than people have had in mind; and there will be much heavier Treasury financing in the second half of 1970 than in the corresponding period of 1969.

The problem of inflation is still our number one economic problem. It seems to me that the rate of growth in the money supply in the first half of 1970 has been about right.

Concerned about the delicacy and uncertainty of financial markets, I would favor alternative A of the draft directives prepared by the staff, adding to the second paragraph the words "taking account of the Board's regulatory action effective tomorrow." Expansion of the money supply during the third quarter of 1970 at an annual rate of 5 per cent or a bit less would seem quite satisfactory to me. It is hard to make a judgment regarding growth in bank credit in view of the change in Regulation Q. It would not be disturbing to see a large increase in time deposits resulting merely from a shift from commercial paper to certificates of deposit.

In the light of market uncertainties there could be substantial movements, up or down, in short-term market rates. It would seem desirable to lean against upward pressures if they develop, but it would be undesirable to seek to peg rates.

Mr. Treiber added that in the interests of precision he would suggest substituting "insolvency" for "bankruptcy" in the reference in the first paragraph of the draft directive to "the bankruptcy of a major railroad."

Mr. Morris remarked that the System's most important action today--the change in Regulation Q--had already been taken. That move

6/23/70

-59-

would give the banking system the element of flexibility that was critically needed at this stage.

Four weeks ago, Mr. Morris continued, the Committee had changed the form of its directive temporarily because of the chaotic state of financial markets. Since that time the markets had stabilized considerably, and the relatively calm reaction to the Penn Central situation during the last few days had been quite reassuring. Accordingly, he thought it would be desirable at this time to return to a directive focusing on the aggregates, although he would want a strong proviso clause guarding against the re-emergence of excessive market pressures.

Alternative B of the staff's draft directives seemed to meet those requirements, Mr. Morris observed. However, he would favor deleting the reference to bank credit in the statement that "...the Committee seeks to promote moderate growth in money and bank credit..." because of the likelihood that the Q change would result in a more-than-moderate increase in that aggregate. In fact, he considered Mr. Partee's estimates of the likely increase to be on the low side; he expected banks to act aggressively in expanding their CD's outstanding.

Mr. Morris said he would favor providing the reserves needed to permit the increase in CD's, but only so long as growth in the money supply did not exceed a 4 to 5 per cent annual rate. The case made by the staff for a faster rate of growth of money struck him as interesting but not very convincing. He thought the Committee

6/23/70

-60-

should hold to the target of moderate growth in money, at least until there were signs that a major shortfall from the GNP projections was in prospect.

Mr. Coldwell observed that some of those around the table seemed to be dissatisfied with the recent trend of the economy. He personally was reasonably satisfied with the degree to which activity had been slowed, and he hoped it could be kept down for a while longer. At the same time, he could not accept the pattern described in the staff's GNP projections for the coming year as being in the public interest. He expected some further increase in unemployment in the short run as a result of continuing cutbacks in defense spending, but he hoped that the unemployment rate would begin to drop after that. Economic activity was likely to slow further in the third quarter--appropriately, he thought--but he would expect some rebound in the fourth.

As to policy for the coming period, Mr. Coldwell favored continuing to emphasize the objective of stability in money market conditions, and he therefore supported alternative A of the draft directives. Financial markets were still exposed to unsettling developments, and he would give the Manager a wide degree of leeway to deal with unsettlement. Finally, he would want to moderate somewhat any surge in bank credit that developed as a result of strong demands for business loans, either to substitute for other forms of credit, to finance increases in inventories, or to supply working capital.

Mr. Swan said he would agree with most of what had already been said in the go-around. He believed the Committee's longer-run objective of moderate growth in money and bank credit was appropriate to the needs of both the domestic economy and the balance of payments, and that the Committee would have to hold to that objective if its anti-inflationary effort was to prove successful. Like Mr. Morris, he had found some parts of the staff's presentation to be unconvincing, and he thought it was important to remember that the substantial amount of Treasury financing scheduled for the second half would limit the Committee's freedom of action then.

While the situation in financial markets had improved a great deal since the last meeting, Mr. Swan continued, the persisting uncertainties seemed to him to be great enough to warrant maintaining the emphasis on market conditions, as called for by alternative A. He would favor providing the reserves required to support the growth of CD's expected to result from the change in Regulation Q, since the additional CD's would generally be substitutes for outstanding commercial paper. However, he would not want to delete the reference to bank credit from the second paragraph of the directive. He thought the suggested insert, "... taking account of the Board's regulatory action effective tomorrow ...," would deal with the problem noted by Mr. Morris, and he favored its inclusion.

Mr. Strothman remarked that he favored the type of directive suggested by Mr. Partee, combining the money market

6/23/70

-62-

emphasis of alternative A with the conditions specified in connection with alternative C.

Mr. Baughman said he thought the situation continued to call for an essentially accommodative monetary policy. Accordingly, he favored alternative A. He would not be overly concerned about a surge in bank credit resulting from the change in Regulation Q. At the same time, he did not think the Manager should be instructed to resist aggressively a strong rise in bill rates, if one developed. The Manager's major concern, in his judgment, should be to maintain orderly market conditions.

Mr. Clay commented that the Federal Reserve System continued to have the problem of balancing price inflation restraint against a severe decline in economic activity in the process of restoring orderly economic growth along with price stability.

With that in mind, Mr. Clay said, alternative B of the draft economic policy directives appeared to be the appropriate choice today. Credit market considerations were very important, but the situation that had led to the directive adopted at the last meeting of the Committee did not exist now. If severe credit market strains did develop, action could be taken under the proviso clause.

While the price inflation problem had proven to be very difficult, Mr. Clay continued, substantial progress had been made toward the ultimate solution. Primary emphasis upon credit markets, as provided by alternative A, might lead to unwarranted expansion in

bank credit and money and endanger that ultimate success. Likewise, the greater degree of expansion in bank credit and money provided by alternative C ran the risk of stimulating price inflation. The targets indicated in the blue book for alternative B appeared to be more nearly in line with the basic goals of policy.

Mr. Heflin remarked that as a general matter he continued to favor the moderate expansion of liquidity envisaged in the directive the Committee had adopted on May 5. But he thought the Committee continued to confront a potentially dangerous situation in financial markets, and it seemed to him that for the next month or two maintenance of orderly markets should take priority over the Committee's intermediate- or long-term objectives with respect to the aggregates. While the near-crisis conditions prevailing at the time of the Committee's last meeting had passed, the basic undertone of the market remained weak and uncertain, and the market was highly vulnerable to such developments as the Penn Central insolvency. With the heavy Treasury financing scheduled for the next two months, credit markets were rather clearly in for a severe testing period. Under the circumstances, he believed the Committee had to focus primary emphasis on market conditions. For that reason, he favored alternative A for the directive, and he trusted that it would be possible to get through the coming period with no greater growth in the aggregates than was projected under that alternative.

6/23/70

-64-

Mr. Mitchell said he, too, preferred alternative A in the present circumstances. Given the existing uncertainties, he would not want to try to specify an appropriate growth rate for the money supply at this time. He would note, however, that while growth in the money supply at a 6, 8, or even 9 per cent annual rate for as long as a quarter would not disturb him, he would not want to see such rapid growth extend over a half-year. Accordingly, he did not favor the staff's recommendation for a 6 per cent target for growth in money over the second half. It would be better for the System to provide additional liquidity over the summer months and then to back off in the fall.

In his view, Mr. Mitchell observed, the Manager should resist any rise in interest rates; in general, he thought the Committee should be aiming at lower rates. As to the possible growth rate in bank credit following the Board's action, he would consider any estimates made at this juncture to be pure speculation. He would not object to dropping the reference to bank credit from the second paragraph of the directive, as Mr. Morris had suggested. If the reference was retained he would want to supplement the proposed additional phrase mentioning the Board's regulatory action with language referring to the possibility of consequent shifts of credit flows from the market to banking channels.

Mr. Daane remarked that, if the Board had not acted on Regulation Q this morning, he would have favored an easier open

6/23/70

-65-

market policy--in light of the greater-than-expected softness in the economy, the risk of further softening, and the continuing strains in financial markets. Given the Board's action, he was a little less certain about the appropriate instructions to the Manager. In general, he thought the System should lean against the wind of a cumulating recession, but not so hard as to provoke a resurgence of inflationary expectations.

On balance, Mr. Daane favored alternative A with the addition of the proposed reference to the Board's action. He agreed with Mr. Mitchell that the Committee should be aiming for somewhat lower interest rates and thought it might be useful to add a statement to that effect to the directive. However, he had no specific language to suggest.

Mr. Maisel said he would like to see an increase of \$70 billion in nominal GNP in the coming fiscal year. If that could be brought about by greater credit availability and lower interest rates, he thought such means would be preferable to the use of fiscal policy. Also, since he agreed with the staff that current monetary policy would result in inadequate GNP growth, he favored a change. In particular, he believed that the adoption of alternative D for the directive would be desirable. With regard to the aggregates, he thought the adjusted credit proxy might grow at a 9 to 10 per cent annual rate as a result of the change in Regulation Q. However, he hoped the money supply would not grow at a rate of more than 6 per cent.

6/23/70

-66-

Mr. Maisel noted that while alternatives A and D both emphasized conditions in financial markets, both also referred to longer-run objectives for the monetary aggregates. Alternative D called for somewhat greater growth in the aggregates than in the first half of the year. He hoped those members who favored alternative A would indicate their preference with respect to the longer-run objectives for growth in the aggregates.

Mr. Brimmer said he favored alternative A for the directive, with the language changes that had been suggested. In response to Mr. Maisel's final comment, he would not want to see growth in the monetary aggregates at rates substantially greater than those shown in the blue book in connection with alternative A.

The outlook for bank credit was, of course, affected by the Board's action on Regulation Q, Mr. Brimmer remarked. It was his hunch that the resulting increment to bank credit growth in July--and certainly in the third quarter--would be greater than Mr. Partee had indicated. Unduly rapid bank credit growth would, among other things, stimulate expectations of a greater easing of monetary policy than the Committee intended. He would not want to accept all of the bank credit growth that might result from this morning's action; rather, he would want to limit the additional growth to that representing substitution for commercial paper, of the sort the Board's press release suggested would not be inflationary. In line with that

6/23/70

-67-

view he would favor retaining the reference to bank credit in the second paragraph of the directive.

Mr. Sherrill observed that the staff's presentation had been quite helpful in giving a longer-range perspective on the economic outlook and on the implications of various policy courses. He believed the economy was drifting down at a faster rate than had been anticipated, and that if the projections were wrong the error was likely to be in the direction of a shortfall. He held that view mainly because he thought the process of cutting back on planned capital expenditures now had developed considerable momentum. Because of such cutbacks, economic activity might be below current projections by the end of the year even if there had been a turnaround in other categories of spending.

Under those circumstances, Mr. Sherrill remarked, he considered the policy course called for by alternative B of the draft directives to be too restrictive. He preferred alternative A to C because of the continuing uncertainties in market conditions. However, if the market situation were to stabilize, he would want the Manager to move to the specifications associated with C rather than B.

Mr. Hickman said he did not think the differences in the aggregate growth rates associated with the alternative draft directives were very great, at least as they pertained to the period until the next meeting. He still thought that longer-run growth in the money supply at about the 4 per cent annual rate called for under alternative B was appropriate to the underlying economic situation, and he would

6/23/70

-68-

want to return to that growth rate as soon as feasible. He was inclined toward alternative B also because the publication of such a directive 90 days hence would have a favorable effect on the public's appreciation of the System's intentions. However, he recognized that the present was not the time to fight to hold growth in money down to a 4 per cent rate, in view of the apprehensive state of the market and the liquidity squeeze. Thus, while he would favor alternative B for the directive, he thought the Manager should not press unduly hard to limit growth in money, and that he should be prepared to move quickly to the specifications of alternative A, or even those of C, if market conditions became unsettled.

Mr. Eastburn remarked that he did not take much comfort from the fact that the second-quarter growth rates for the aggregates apparently were coming out very close to the Committee's targets. He did not understand how that had happened, and thought it might have been due to random factors that could as easily have worked in the opposite direction.

As to open market policy, Mr. Eastburn would avoid any actions that would provide a signal of easing in addition to the announcement effect of the Board's Regulation Q action. He was inclined toward alternative B for the directive, on the understanding that the Manager would be able to take any necessary emergency action under the proviso clause. However, he had no objections to alternative A.

Mr. Kimbrel said he was in general agreement with the tone of the staff's analysis this morning, which suggested that the weaknesses in the economy were now greater and were likely to extend longer than had been anticipated earlier. He was perhaps inclined to see more weakness in the third quarter than implied by the Board staff's GNP projection; he was a little more pessimistic about the outlook for consumer spending and business fixed investment.

Not too long ago, Mr. Kimbrel continued, the actions of people--especially businessmen--conformed fairly well to their statements about continued inflation. Now he was not sure that that was the case. One discrepancy was involved in the belt tightening that seemed to be going on in businesses throughout the Sixth District, and, he understood, throughout other parts of the country as well. Businesses of a wide variety were making special efforts to reduce costs, sometimes laying off a considerable number of workers. It seemed to him that, if those businessmen really believed that inflationary forces were as strong as they said, they would be meeting rising costs by raising prices. Instead, either currently declining sales or their estimates of future resistance to higher prices had led them to try to restore profit margins in ways other than by increasing prices.

Since he believed that there was already an impetus toward a greater dampening of inflationary pressures, Mr. Kimbrel observed, it followed that the Committee's past moves toward less monetary restraint

6/23/70

-70-

were appropriate. While it was not clear how great the shift toward ease should have been, the adjustment process was already in motion and he did not believe too much harm had been done by the temporary and short periods of excessive stimulus that had taken place from time to time.

At present, Mr. Kimbrel said, he hoped the Committee's policy would be in line with alternative B, but like some others he would not want to fight to hold growth in the aggregates down to the rates called for under that alternative. If economic conditions turned out to be as projected, the rate of unemployment and capacity utilization would continue to worsen through mid-1971. If the Committee could be certain of that, the 6 per cent annual rate of growth in money implied by alternative C would be more appropriate. But given the present uncertainties, the fact that many assumptions must underlie any projection, and the impending Treasury financing, it seemed to him that a more cautious approach was appropriate at the moment. That posture could, of course, be changed should economic developments turn out to be even worse than anticipated at present.

Mr. Francis said that, of the four alternative directive drafts, he favored alternative B calling for a 4 per cent annual rate of growth in money from June to September. Even that expansion of money would result in net growth over the period since the Committee changed policy last winter at a rate that he considered more than moderate.

Mr. Robertson made the following statement:

Even though immediate financial problems are commanding much of our attention, it is essential that the monetary policy decision we reach today be carefully related to the fundamental state of the economy. Many of today's problems are an inevitable outgrowth of our past economic excesses and the fundamental efforts to correct them which we have struggled so long to bring to fruition. While we need to deal effectively with these transitional problems, we must do so in ways that do not prejudice our program for curing the basic inflationary virus in our economic system.

I think a fair reading of the cumulative evidence is that we are continuing to make headway in dealing with inflation. Excess demand has been eliminated, and the cautious state of retail sales and the weakening outlook for plant and equipment expenditures suggest that the risks of a resurgence of an inflationary atmosphere are diminishing. With markets soft, profits down, and unemployment rising, pressures are also building up against continuation of excessive wage and price increases. Nonetheless, we have no hard evidence as yet of a widespread slowdown to tolerable levels of wage and price advance. It seems inevitable that more months still lie ahead of us before any generally accepted signs of success on that score can be in hand.

This economic situation, it seems to me, argues for caution in any movement of monetary policy, but I believe it is compatible with some careful adjustment of our monetary policy targets in the interest of achieving a more orderly transition with a minimum of financial hardship. Given the signs of financial strain that we see flashing here and there inside and outside the banking system, I believe it would be timely for us to ease up just a bit more on the monetary reins--but not much.

Given the uncertainties in some of our financial markets, I conclude that the most workable means of effecting this policy change would be to direct the Manager to achieve somewhat easier conditions in the money and short-term credit markets. But he should proceed on that course only so long as our financial aggregates, and particularly the money supply, do not rise excessively. What is an "excessive" rate of growth of M_1 is, of course, a matter of judgment. I do not like the indicated negative money supply growth for June, even though I recognize

it is likely to be followed by a sizable July increase and that some of the factors that tend to make July high are the obverse of those that tend to make June low. I would prefer to have the Manager take the 4.5 per cent average rate of growth for June and July combined that falls out of the specifications for alternative C as his upper limit. That is, if money supply growth seems to be running above this track between now and the next meeting of the Committee, he should cease his market-easing operations. I believe this kind of policy preference can be easily associated with the language of alternative A; and with this understanding of its meaning I would be prepared to vote for that alternative.

Chairman Burns said it appeared that a majority of members favored a directive with a second paragraph along the lines of alternative A. He had independently arrived at the same preference, and would add only one observation to the discussion. He was somewhat concerned about the future course of interest rates; he hoped that the Desk would watch interest rates closely, and do what it reasonably could to nudge them down. He said that because he thought it was now clear that the economy was in a recession. Unfortunately, the hypothesis to which he had referred at other recent meetings had been confirmed by the facts.

The Chairman remarked that alternative A, with certain proposed modifications, appeared to be a reasonable choice under the circumstances. It was consistent with the Board's action on Regulation Q this morning, and it looked to the future as well as to the past. The modifications he had in mind included the addition of the reference to the Board's action proposed in the supplementary notes distributed by the staff, and of the reference Mr. Mitchell

6/23/70

-73-

had suggested to the possibility of consequent shifting of credit flows. For the first paragraph he thought the Committee would want to accept Mr. Treiber's suggestion to substitute the word "insolvency" for the word "bankruptcy" in the staff's draft.

It was suggested that in the interest of clarity the proposed reference to the Board's action be described as "effective June 24" rather than "effective tomorrow."

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

The information reviewed at this meeting suggests that real economic activity is changing little in the current quarter after declining appreciably earlier in the year. Prices and costs generally are continuing to rise at a rapid pace, although some components of major price indexes recently have shown moderating tendencies. Since late May market interest rates have shown mixed changes following earlier sharp advances, and prices of common stocks have recovered part of the large decline of preceding weeks. Attitudes in financial markets continue to be affected by uncertainties and conditions remain sensitive, particularly in light of the insolvency of a major railroad. In May bank credit changed little and the money supply rose moderately on average, following substantial increases in both measures in March and April. Inflows of consumer-type time and savings funds at banks and nonbank thrift institutions have been sizable in recent months, but the brief spring upturn in large-denomination CD's outstanding at banks has ceased. The over-all balance of payments was in heavy deficit in April and May. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging

6/23/70

-74-

the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, in view of persisting market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall continue to be conducted with a view to moderating pressures on financial markets. To the extent compatible therewith, the bank reserves and money market conditions maintained shall be consistent with the Committee's longer-run objective of moderate growth in money and bank credit, taking account of the Board's regulatory action effective June 24 and some possible consequent shifting of credit flows from market to banking channels.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, July 21, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.


Secretary

For immediate release.

June 23, 1970.

The Board of Governors of the Federal Reserve System today suspended, effective tomorrow (Wednesday, June 24), ceilings on interest rates payable by member banks on certificates of deposit and other single-maturity time deposits in denominations of \$100,000 or more with maturities of 30 through 89 days.

Prior to the suspension, which will remain in effect until further action by the Board, the ceilings on such deposits had been 6-1/4 per cent for maturities of 30-59 days and 6-1/2 per cent for maturities of 60-89 days.

In taking the action, the Board recognized that there could be unusual demands upon commercial banks for short-term credit accommodation as a consequence of current uncertainties in financial markets. If this occurs, such increases in bank loans would not constitute an increase in total credit flows, to the extent that they simply represented a transfer of borrowings from other financing avenues, as for example the commercial paper market.

Under these circumstances, appropriate accommodations in bank lending, the Board said, would be a constructive element in the process of adjustment to changing financial conditions and would not interfere with the continuing objective of curbing inflation.

The Board's action was taken after consultation with the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board.

No change was made in the ceilings applicable to longer-term certificates of deposit of \$100,000 or more, which remain at 6-3/4 per cent for maturities of 90-179 days, 7 per cent for 180 days to one year, and 7-1/2 per cent for one year or more. Likewise, no change was made in the ceilings on savings deposits or time deposits (including certificates of deposit) of less than \$100,000, on which the maximum rates payable range from 4-1/2 to 5-3/4 per cent.

Attached is the text of an amendment to the Board's rules governing the payment of interest on deposits (Regulation Q), effecting the Board's action.

June 22, 1970

Drafts of Current Economic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on June 23, 1970

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real economic activity is changing little in the current quarter after declining appreciably earlier in the year. Prices and costs generally are continuing to rise at a rapid pace, although some components of major price indexes recently have shown moderating tendencies. Since late May market interest rates have shown mixed changes following earlier sharp advances and prices of common stocks have recovered part of the large decline of preceding weeks. Attitudes in financial markets continue to be affected by uncertainties and conditions remain sensitive, particularly in light of the bankruptcy of a major railroad. In May bank credit changed little and the money supply rose moderately on average, following substantial increases in both measures in March and April. Inflows of consumer-type time and savings funds at banks and nonbank thrift institutions have been sizable in recent months, but the brief spring upturn in large-denomination CD's outstanding at banks has ceased. The over-all balance of payments was in heavy deficit in April and May. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, in view of persisting market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall continue to be conducted with a view to moderating pressures on financial markets, while, to the extent compatible therewith, maintaining bank reserves and money market conditions consistent with the Committee's longer-run objective of moderate growth in money and bank credit.

Alternative B

To implement this policy, the Committee seeks to promote moderate growth in money and bank credit over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective; provided, however, that operations shall be modified as needed to counter excessive pressures in financial markets, should they develop.

Alternative C

To implement this policy, the Committee seeks to promote somewhat greater growth in money and bank credit over the months ahead than in the first half of this year. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with that objective; provided, however, that operations shall be modified as needed to counter excessive pressures in financial markets, should they develop.

CONFIDENTIAL (FR)

June 23, 1970

Supplementary notes on draft directives

1. As a result of the Board's action this morning on Regulation Q ceilings, it is likely that in coming months higher bank credit growth rates than specified in the blue book will be associated with the growth rates specified there for the money supply in connection with each of the alternatives for the second paragraph of the directive. The additional bank credit will, of course, be at least partly in substitution for nonbank commercial paper outstanding.

2. Whatever the Committee's preference for the second paragraph, it may want to incorporate a reference to the Board's regulatory action. For alternatives B and C, this might be done by inserting, after the phrase "To implement this policy," the phrase "and taking account of the Board's regulatory action effective tomorrow." For alternative A, it probably would be desirable to recast the paragraph into two sentences, as follows:

"To implement this policy, in view of persisting market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall continue to be conducted with a view to moderating pressures on financial markets. To the extent compatible therewith, the bank reserves and money market conditions maintained shall be consistent with the Committee's longer-run objective of moderate growth in money and bank credit, taking account of the Board's regulatory action effective tomorrow."

June 23, 1970

Alternative D for second paragraph of current economic policy directive

To implement this policy, in view of persisting market uncertainties and liquidity strains, open market operations until the next meeting of the Committee shall continue to be conducted with a view to moderating pressures on financial markets. To the extent consistent therewith, operations shall be conducted with a view to promoting somewhat greater growth in money and bank credit over the months ahead than in the first half of this year, taking account of the Board's regulatory action effective tomorrow.

Note: If the Committee favors the foregoing language, it might want to specify the money market conditions associated with alternative C in the blue book (in paragraph 22 on pages 15-16). Also, "somewhat greater growth" in the aggregates might be defined as in connection with alternative C (in paragraph 21), with allowance for the additional bank credit growth likely to be associated with the Board's regulatory action.

ATTACHMENT E

SUBMISSION BY MR. FRANCIS CONCERNING BASE
PERIOD FOR MEASURING RECENT CHANGES IN MONEY

Since last February, this Committee has specified moderate rates of growth in the money stock and bank credit as desired intermediate goals of monetary policy. As events have unfolded, a great amount of confusion has come about regarding the rates of expansion which have been achieved. This confusion results from our failure to specify and stick to a base period from which rates of change in these monetary aggregates are to be measured.

When, in February, the Committee first opted for a moderate rate of growth of money and credit did we mean from February, from January, from December, from the first quarter of 1970, or the fourth quarter of 1969? And did we mean to include or exclude all or some of the great temporary bulge of the beginning of the year?

If we are to use monetary aggregates successfully in conducting monetary policy, we must select a base period to be unchanged until there is a change in policy. Once a common reference point is established, then deliberations of this Committee can more fruitfully be concerned with the appropriate rate of growth in money and bank credit over the following several months.

Specification of an agreed base for planned rates of monetary expansion for a moderately long period need not imply inflexible monetary policy. Either the base period or the desired rate of monetary growth can be altered as our judgment changes regarding what is needed. Such a change, however, would appropriately be viewed as a change in FOMC policy. Specification of a base and rate of growth therefore would require that short-run deviations from the desired growth path be corrected in a relatively short period to bring monetary expansion back to the specified path. I am disturbed by the present tendency to accept past deviations from a specified path and to establish implicitly or explicitly a new base at each FOMC meeting. Following such a procedure virtually nullifies the use of monetary aggregates.