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, January 12, 1971, at 9:30 a.m.

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

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

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

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

Messrs. Bernard and Leonard, Assistant Secretaries, Office of the Secretary, Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors

Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Associate Adviser, Division of International Finance, 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
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Mr. MacDonald, First Vice President, Federal Reserve Bank of Cleveland
Messrs. Eisenmenger, Link, Taylor, and Tow, Senior Vice Presidents, Federal Reserve Banks of Boston, New York, 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. Geng, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on December 15, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on December 15, 1970, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period December 15, 1970, through January 6, 1971, and a supplemental report covering the period January 7 through 11, 1971. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that developments in the foreign exchange markets over the turn of the year had, by and large, followed the expected pattern. Year-end window-dressing demands on the Euro-dollar market had tended to relieve pressures on the dollar and had accommodated a further sizable runoff of Euro-dollar borrowings by U.S. banks. No further drawings on the swap network had become necessary. The very heavy return flow of funds to Switzerland had been entirely financed by market swaps, amounting to more than $1 billion, put out by the Swiss National Bank.

Since the turn of the year, Mr. Coombs continued, the markets had been more or less marking time. The main feature of daily trading had been strong buying pressures on both sterling and the lira. In the case of sterling, which had gone over par this morning, tight money plus favorable seasonal factors had been mainly responsible for the buying pressure. Over the next month or so, reserve gains by the Bank of England and the Bank of Italy together might well reach \$1.5 billion or so. Both central banks probably would hold onto the dollars and thus provide some offset to whatever further repayments of Euro-dollar borrowings might be made by U.S. banks.

In that connection, Mr. Coombs said, the Treasury had decided to take advantage of the prospective reserve gains of the Bank of England to liquidate gradually its holdings of \$122 million of guaranteed sterling, and the Treasury would have no objection if the Federal Reserve pursued a similar course with respect to its holdings of \$148 million. The Bank of England had no other official debt reaching maturity during the first quarter except that under the first sterling balance arrangement (of which the U.S. portion was in the form of guaranteed sterling) and it agreed that the time had come to liquidate the remainder of U.S. guaranteed sterling holdings, assuming that developments with respect to the U.K. balance of payments and reserves turned out as expected.

At the Basle meeting last weekend, Mr. Coombs said, the normal group discussions were curtailed owing to the tragic death of Gabriel Ferras and to certain problems arising out of the resignation of President Ansiaux of the National Bank of Belgium. At the Sunday afternoon meeting, however, President Zijlstra distributed a BIS staff memorandum on the structure and functioning of the Euro-dollar market. He (Mr. Coombs) would expect that in future BIS discussions of the matter considerable attention would be paid to various national regulations affecting the Euro-dollar market, such as the Federal Reserve's Regulation Q and the recent British moves toward restricting borrowings in that market. A second problem that was arousing some concern was the growing practice by central banks of placing official reserves in the Euro-dollar market, thereby creating the risk of double-counting of dollar reserves and unnecessarily complicating the financing of the U.S. payments deficit.

Mr. Robertson asked Mr. Coombs to clarify his observation that placement of official reserves in the Euro-dollar market involved a risk of double-counting of dollar reserves.

Mr. Coombs said he might best clarify the matter by using an illustration. Recently, a number of Italian agencies had borrowed Euro-dollars at interest rates which were, of course, in excess of the rates prevailing in the U.S. market. The Bank of Italy had then placed part of its dollar holdings in the Euro-dollar market, for the purpose of obtaining a matching interest return. The funds so invested by the Bank of Italy might have been borrowed by nationals of other European countries and might subsequently have found their way into the reserves of the central banks of those countries. With the Italians showing no change in their dollar reserves and with the other central banks showing an increase, the total dollar reserves of the central banks affected obviously would seem to have increased.

Mr. Brimmer asked whether other European central banks also could be expected to invest dollar holdings in the Euro-dollar market.

Mr. Coombs replied that until recently that practice had been followed only by smaller countries; central banks of the major countries had tended to keep their dollar reserves invested in U.S. Treasury securities. Now some of the larger central banks were beginning to invest in the Euro-dollar market. A debate on the appropriateness of that practice was under way, but there was a real risk that it would grow.

By unanimous vote, the System open market transactions in foreign currencies during the period December 15, 1970, through January 11, 1971, were approved, ratified, and confirmed.

Mr. Coombs then said he had certain recommendations to make relating to renewals of System drawings on the swap lines. Two drawings on the National Bank of Belgium, totaling $65 million, would mature for the first time on January 28 and February 10, respectively. He would recommend renewal of those drawings if it did not prove possible to make arrangements with the Treasury for funding them by the maturity dates. Also, four drawings on the Netherlands Bank would reach maturity soon. These included a $30 million drawing maturing for the first time on January 26 and three drawings, totaling $130 million, maturing for the second time in the period from January 27 through February 17. Discussions were actively under way with the Treasury and with the Dutch officials regarding possible arrangements for covering those drawings, perhaps by a Treasury drawing on the International Monetary Fund or by the use of special drawing rights. He was hopeful that the arrangements would have been completed by the time the drawings matured, but he would recommend their renewal in the event that did not prove to be the case.

Possible renewal of System drawings on the National Bank of Belgium and on the Netherlands Bank was noted without objection.

Mr. Solomon then made the following statement on international developments:

> Balance of payments statistics for 1970 are still incomplete since a full accounting of year-end flows is not yet available. It appears, however, that the deficit on the official settlements basis will be between $10 billion and $11 billion. This figure is considerably higher than any I have seen reported in the press to date and may be some $3 billion higher than is generally expected by the public. Repayments of Euro-dollar borrowings by American banks, which accounted for a large share of this deficit, continued sizable up to the year end, and for the first half of

the current reserve computation period ending January 20, 1971, the liabilities of these banks to their branches abroad are estimated to have averaged almost $1 billion below their average level in the computation period ending December 23, 1970.

As was reported in the green book,[1] the underlying balance of payments deficit on the liquidity basis showed a disappointing degree of improvement in 1970. The U.S. trade balance, after strengthening over the first half of 1970, has eroded rather rapidly since mid-year and the surplus disappeared completely in November. For the year as a whole the surplus is not likely to be much higher than $2 billion, whereas a surplus of $3 billion appeared likely not too long ago. Information on capital movements suggests that outflows--primarily direct investments permitted by Department of Commerce regulations--were larger last year than in 1969, and foreign purchases of U.S. securities were smaller in 1970 than a year earlier, although some pickup in such purchases has occurred in recent months.

With regard to the implications of such developments for monetary policy, I continue to believe that the need to prevent a resurgence of inflation on domestic grounds is reinforced by balance of payments considerations. However, within the range of policies under deliberation, I do not believe the balance of payments should push the Committee's decision one way or the other. I would supplement that view with two observations. First, wherever possible in the implementation of the Committee's policy, it would appear desirable to minimize downward pressure on short-term rates and this may imply some purchases of Treasury bonds. Secondly, since the major immediate problem in our balance of payments is the flow of Euro-dollars, there would appear to be a need for special measures to control that flow.

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

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

Mr. Partee made the following statement concerning economic developments:

> Now that the GM strike is well behind us, everyone is looking for evidence that an underlying recovery trend in the economy is beginning to emerge. So far, there isn't much to report. Output in the automobile industry and its supplier industries rebounded in December and further increases are scheduled for January and February, but production in most other activities appears to have been unchanged or a little lower. Our estimate is that the production index rose 2-1/4 points last month; but with cars, trucks, and auto parts and supplies accounting for a rise of about 2-1/2 points in the index, the other industries obviously did not contribute, net, to the gain. The employment data for December that became available this past week were also disappointing. Total nonfarm employment rose by 300,000 but this was less than is accounted for by the return to work of strikers and related workers. Employment in trade declined considerably for the second month in a row, while the gains in other activities were very small.
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> The unemployment rate, as you all know, reached 6 per cent last month. The 0.2 percentage point increase from November occurred despite the re-employment of workers in auto-supplying industries, and it put the over-all unemployment rate one-half percentage point higher than in the September survey week, before the auto strike had begun. The November-to-December rise reflected higher unemployment among men and women aged 25 and over, rather than among younger workers. In the past year the unemployment rate has risen from 3.5 to 6.0 per cent--a rise, in terms of absolute numbers, of 2 million persons. Included in this increase are more than 1 million adult men--20 and over--and nearly 600,000 adult women, and the vast majority reported that they are looking for full-time work. The teenage unemployment rate is of

course much higher than that for adults, but it has increased relatively less over the past year than the rate for either men or women.

There have been some pieces of favorable economic news since the last meeting of the Committee. Retail sales, after a slow start, seem to have turned out relatively good for the Christmas season. Preliminary estimates are that sales--exclusive of auto, building materials, and farm implement dealers--rose nearly 1 per cent from November to December and were about 8 per cent above a year ago--appreciably more than the rise over the same period in retail prices. Manufacturers' new orders rose moderately in November--again excluding autos--with orders for capital equipment surprisingly strong. And the year-end Government survey of plant and equipment spending plans indicates a rise of 1-1/2 per cent in 1971--hardly a strong showing, but confirmation at least that the bottom is not likely to drop out of the capital goods markets. Both housing starts and building permits were strong again in November and have exceeded our prior expectations. Finally, the wholesale price index was about unchanged in December, following a decline in the previous month. In both instances, weakness in prices of farm products and foods was mainly responsible, but the trend of industrial raw materials prices also has flattened markedly over recent months.

We continue to project a strong temporary resurgence in the economy, with GNP increasing in the first quarter at an annual rate of nearly $30 billion, as GM production is pushed in order to reinventory dealers and hopefully to recoup some of the sales lost in the fall. But once that temporary stimulus has passed, and abstracting from expectations of a steel strike next summer, we do not see sufficient strengths in the economy to maintain a healthy growth rate. Housing, State-local outlays for public facilities, and Federal expenditures--mainly for transfer payments and grants-in-aid--doubtless will be expanding rapidly. But business capital spending promises at best to be essentially flat, even allowing for the near-term effects of the new depreciation rules, and there seems no basis at present for expecting a major boost from consumers, over and above the normal increase in spending likely to accompany rising disposable incomes. Nor does an upsurge in inventory investment--often the source of stimulus in the initial stages of past recoveries--appear very likely. The most recent data indicate larger inventory accumulation by manufacturers, and this seems more likely to have been involuntary than anticipatory, given the environment of generally sluggish production and high ratios of inventories to current sales and order backlogs.

Accordingly, Board staff projections are for a continued slow rate of economic growth. Current real growth, averaging together fourth-quarter 1970 and first-quarter 1971 changes in GNP, is estimated to be at slightly over a 2 per cent annual rate, and expansion in the following three quarters of 1971 is projected on average at less than a 3 per cent annual rate. Such an expansion would very likely result in a dampening of price inflation, and it seems to me quite possible that our projection of a 4.3 per cent rise in the GNP deflator this year will prove to be too high. But such an expansion also will clearly not provide jobs for anything like a normal growth in the labor force.

Board staff projections deviate most conspicuously from those that I have seen presented by private business economists in this estimate of unemployment. Most forecasts of 1971 GNP range from $1,040 to $1,050 billion, while ours is $1,044 billion. Most projections of real growth range from 2-1/2 to 3-1/2 per cent for 1971; ours is 2-1/2 per cent. But I have seen no other estimate of an unemployment rate for the year averaging above 6 per cent, while ours is 6.4 per cent. Accordingly, we have taken another close look at our unemployment estimates, and I continue to think that they are reasonable. The problem is that there will be a large increase in population of labor-force age, and additionally, that the next year will see a significant further decline in the size of the armed forces. Perhaps the lack of jobs will keep people from entering the active labor force, but we have already allowed for a small decline this year in the labor force participation rate. Perhaps productivity will rise far less than normal, but we have already estimated a productivity increase of only 2 per cent, which seems small in view of the continuing widespread emphasis by business on cost-cutting. Or perhaps real growth will prove to be somewhat higher than we have projected, thus creating new jobs and reducing unemployment correspondingly.

The point is, however, that it would take a great deal more economic expansion than we have projected to bring the unemployment rate down substantially or to put new demand pressures on our available resources. In view of this, there seems to me little risk of pursuing too expansive a policy--provided that it is quickly reversible--and considerable risk that public stabilization efforts will not be expansive enough. We have had a shortfall in monetary expansion from our expectations of a month ago, and there may also have been some shortfall in terms of economic activity. Now we should be prepared to see a large increase in money demand to accompany a temporary spurt in economic activity; such an expansion should not only be encouraged but nurtured if we are to make a further contribution to stimulation of the economy. Growth in the narrowly defined money supply this quarter at an 8-1/2 per cent rate sounds very high, but it is a product of the unusual economic situation and of the past shortfall in monetary growth. I believe that further reductions in interest rates should be sought in order to spur satisfactory economic recovery, and therefore I would recommend the Committee's adoption of alternative C of the proposed directives.[1/]

Mr. Axilrod made the following statement concerning financial developments:

The shortfall in growth of the narrowly defined money supply in December and in early January, as compared with expectations at the time of the last Committee meeting, naturally focuses attention on how and to what extent this shortfall should be made up. In addition, the projection of a large, but temporary, post-strike catch-up in GNP growth for the first quarter of 1971 raises the question of how monetary policy should accommodate itself to such a development. There is also the question--which I would not dismiss out of hand--of how monetary policy might best be positioned against the possibility of a significant shortfall in first-quarter GNP growth.

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

It seems appropriate for open market policy under the circumstances to stress the objective of attaining a first-quarter growth rate in narrowly defined money supply of at least a 7-1/2 per cent annual rate. Looked at arithmetically, the 1-1/2 points over the 6 per cent rate previously sought for the first quarter would compensate for the 1-1/2 points under 5 per cent lost in the fourth quarter. Looked at economically, so high a growth rate will probably be required, if the staff's first-quarter GNP projection is correct, to keep money markets from tightening up and leading to tighter over-all credit conditions than appear to be warranted in view of the longer-run comparative weakness of the economy.

Aiming at so rapid a growth rate for narrowly defined money would also provide some built-in protection against a shortfall in growth of GNP in the first quarter. Should such a shortfall occur, the demand for money might not be sufficient at around going interest rates to lead to a 7-1/2 per cent money growth rate. And more push would be required on the supply side in the sense that a rather considerable further easing of money market and broader credit conditions would likely develop as the Manager attempted to remain on the monetary aggregate target. A substantial credit easing would seem merited under the circumstances as a means of stimulating the economy. Thus, open market policy would at least have helped push interest rates down, might have moved to more rapid money growth even though the economy was weak, and in any event financial markets would be more conducive to stimulating monetary expansion over the balance of the year.

On the other hand, if the economy in the first quarter proves about as strong as expected, transactions demands for money may prove large enough so that the money market may have to be eased only modestly further, if at all, from around a 4-1/2 per cent Federal funds rate. Longer-term interest rates may still continue to decline even if economic activity temporarily surges, as progress against inflation becomes more credible and leads to a narrowing of the unusually wide spreads of long- over short-term rates.

I have been putting some emphasis on the hazard of a shortfall in GNP growth because of experience in the fourth quarter, when a drop in growth of nominal GNP from about a 6 per cent annual rate in the third quarter to a little over 2 per cent was accompanied by a reduction in money supply growth rates from 6 per cent to 3-1/2 per cent, as the degree of easing required in the money market to achieve the Committee's wishes was underestimated. In view of last quarter's experience, it might be advisable for the Committee, assuming it opts for making up the shortfall, to consider being more aggressive in open market operations early in the first quarter.

What I mean is that the Committee might wish to aim at, or at least be willing to accept, a substantially higher growth rate in M_1 in January than the 5-1/2 to 6 per cent currently estimated in order to help assure that there is not another shortfall in monetary growth. This would not only provide a better leg up to a higher quarterly target, but it would make good economic sense. With a large calendar of corporate and municipal issues in the period immediately ahead, and a sizable Treasury refunding to be announced on January 20, the further easing of money market conditions that might be required to accelerate the January M_1 growth rate would be useful. It would help to reduce further bank loan rates and long-term rates, including mortgage rates, and perhaps thereby encourage greater spending on inventories, consumer durables, homes, and other capital goods in this early-year, post-strike period of uncertainties in business and consumer planning. Moreover, even keel will have some force beginning a day or two before January 20, even though its constraints seem to have been attenuated in recent practice. It might be wise to take out some insurance against shortfalls in the aggregates in the few days that remain before that time.

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 December 15, 1970, through January 6, 1971, and a supplemental report covering the period January 7 through 11, 1971. Copies of both reports have been placed in the files of the Committee.

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

> Over the interval since the Committee last met money market conditions fluctuated rather widely, reflecting the typical year-end churning in the markets, accentuated this year by two long holiday week-ends. A near crisis in the Government securities market was averted near the end of December when the major clearing banks reached a settlement with their insurer for continued--although limited--insurance coverage for Government and Federal agency securities. As the period progressed, it appeared that the narrowly defined money supply was falling short of earlier expectations and the Committee's desires, thus leading the Desk to seek progressively easier conditions in the money market.
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> Interest rates generally displayed a mixed pattern over much of the period, following the sharp rate declines in all maturity areas in November and early December. The market for Government securities was affected adversely by the insurance problem noted earlier, and by the approaching Treasury refunding. By the end of the period, however, with economic news remaining sluggish and money market conditions comfortable, the Government securities market closed on a firm note. In the corporate bond market there was some investor resistance to the lower interest rates that had developed in mid-December, but by the end of the period a strong tone had reemerged.
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> Treasury bill rates also backed up somewhat during the period, but ended on a strong note. In yesterday's regular weekly auction of Treasury bills, average rates of 4.64 and 4.63 per cent were established for the new three- and six-month bills, respectively--each down about 15 basis points from the rates established in the auction just prior to the last Committee meeting. Reflecting strong bidding elsewhere, the System bid for six-month bills fell on the stop-out rate with the result that we were not awarded $77 million of bills that we had expected to win.
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> As the written reports make amply clear, the monetary aggregates--particularly the narrowly defined money supply--appear to have turned out substantially weaker than had been projected and below the Committee's

target path. The credit proxy seems to have grown a shade less rapidly than had been expected, but with the rate at 16 per cent in December there is scarcely cause for concern over that measure. Other broader measures of money--as noted in the blue book[1]--also tended to expand more rapidly than M_1 in the fourth quarter, ranging upwards from 9 per cent.

Open market operations had to take into account this developing shortfall in M_1 along with the year-end churning in the money market. A large volume of operations was involved, including over $4 billion in repurchase agreements, $1.3 billion of matched sale-purchase agreements, and nearly $800 million of outright purchases. I might note that, with the need to supply reserves somewhat greater than anticipated at the time of the last meeting, we were able--in supplying reserves--to purchase about $400 million in coupon securities which were amply available during much of the period.

Early in the period, with the aggregates apparently a bit ahead of target, we were aiming at the 5 per cent Federal funds rate called for under the directive. In fact, the funds rate tended to average a shade below 5 per cent. By December 28 the Board staff had already begun to detect a shortfall for December, but New York staff estimates indicated we were still on target. In those circumstances a funds rate under 5 per cent appeared to be quite appropriate. At year-end, available evidence tended to confirm the shortfall, and the Desk aimed at a funds rate around 4-3/4 per cent.

Late last week new data seemed to confirm that there was an even greater shortfall in money supply than had been expected, and accordingly we sought still easier conditions in the money market--aiming at a funds rate around the 4-1/2 per cent level.

The actions at the Desk over the period since the last meeting appear to me to be in line with the directive and with the supplementary comments given by Committee members during the course of the last meeting. I understand, however, that there are some

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

who felt that the Desk was not nearly aggressive enough in trying to combat the shortfall in M_1. I would, therefore, appreciate getting from the Committee members a more precise feel for how far the Committee would like to move towards easier money market conditions in trying to offset a shortfall in M_1.

Looking ahead, if the large rise in GNP projected for the first quarter materializes, we could have a resurgence of demand for money in line with the target path set forth in alternative B of the directive. While we apparently fell well short of the money target in the fourth quarter--although the figures are still subject to revision--there was a large expansion in liquidity that can quickly be converted to money if the demand is there.

As you know, the terms of the Treasury's February refunding will be announced next week. The System holds only about $137 million out of a total of $5.4 billion of the two Treasury notes maturing on February 15. I would plan to roll these over into whatever new issue or issues the Treasury offers on the usual basis. I would also plan to do the same with $155 million of March 15 maturities should the Treasury include these in the refunding. The Treasury may also decide to pre-refund other 1971 maturities, and it might be desirable for the System to break up its large holding of $7.3 billion of November 15 maturities. Should the Treasury's offer include this possibility, I would plan to communicate with the Committee on a plan of action.

One final point--given the easier money market conditions being sought--the Desk could run into problems in trying to inject reserves through RP's on a sufficient scale to meet objectives if the RP's are made at the discount rate. We may, therefore, be required to lower the RP rate. As you know, the continuing authority directive provides an option to make RP's below the New York Bank's discount rate, but not lower than the average issuing rate in the latest auction of 3-month bills. This appears to be sufficient leeway.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period December 15, 1970, through January 11, 1971, were approved, ratified, and confirmed.

Chairman Burns then called for a general discussion of the economic and financial situation and outlook. He suggested that the Committee members focus mainly on those aspects for which their appraisals were substantially different from the staff's. They might also want to direct questions on the economic situation to the staff. However, comments on current monetary policy and the directive might best be postponed until later in the meeting.

Mr. Heflin said he thought that the developments likely to occur in the fiscal policy area would be of prime importance in the Committee's deliberations today and over the next few months. In that connection he was impressed with the figures for the high employment budget shown in the green book in conjunction with the staff's latest GNP projections. According to those figures, the high employment budget would remain in surplus throughout calendar year 1971 and that surplus would be growing at an increasing rate over the course of the year. Yesterday, however, the President had announced a liberalization of the rules for depreciation of equipment for purposes of the corporate income tax, and there were other signs that the Administration might be about to embark on a more activist fiscal policy. He asked Mr. Partee to review the fiscal policy assumptions underlying the latest green book projections and to comment on how those projections might be revised in the light of the tax action announced yesterday and of any further developments expected in the area of fiscal policy. Also, it would be helpful to know whether there were any advance indications of the likely content of the President's budget message.

Mr. Partee replied that the staff's GNP projections for calendar 1971 were based on the assumption that total Federal spending in fiscal 1972 would be about $231 billion. As far as staff people were concerned, the expenditure level to be proposed in the budget message was a closely guarded secret. However, according to the best information available to the staff, the proposed expenditures would be less than the $231 billion assumed--perhaps somewhere in the range of $226 billion to $230 billion. Thus, while some revisions might be called for with respect to the estimates of the distribution of Federal expenditures, an upward revision in the estimated total was not justified on the basis of present information.

In general, Mr. Partee continued, the staff projections did not allow for any new initiatives with respect to spending programs, new taxes, or tax cuts that were not in the mill as of the end of last year. Nor did they allow for the change in rules regarding depreciation that was announced yesterday. As he understood it, the Administration expected that change to reduce revenues by about $2.5 billion in calendar 1971. If that were so, it might call for shading downward the staff's estimates of the full employment surplus over the year. On the whole, however, new projections reflecting the latest fiscal policy developments probably would not be very different from those shown in the green book.

Chairman Burns added that in his judgment the estimate of $231 billion for Federal expenditures in fiscal 1972 was not very far off the mark. Apart from the change in depreciation rules already announced, some tax reductions might be proposed, but under present plans the cuts would not amount to more than $2 billion. On balance, he thought the staff's estimates of the full employment surplus should be reduced somewhat--but not by enough to convert them to a deficit.

Mr. Morris remarked that the bulge in real GNP projected for the first quarter was of considerable importance for purposes of short-run policy making. On the basis of his own reading of the data that had become available in the past few weeks, he had less confidence than he had had in mid-December that the bulge would be of the magnitude the staff had projected then. Accordingly, he had been surprised to find that the staff had revised upward its projection of the first-quarter rise in real GNP. Did that revision mean that the staff was now more confident that the projected bulge would occur? If so, when was that expectation likely to be confirmed by incoming statistics?

Mr. Partee replied that real GNP was shown as rising more in the first quarter in the latest projection than in that of mid-December in large part because the decline in the fourth quarter of 1970 was now estimated to have been greater than the previous projection had suggested in expenditure categories affected by the auto strike. Specifically, the fact that deliveries of trucks and sales of automobiles failed to come up to expectations in December had led the staff to increase its estimates of the declines in both business fixed investment and consumer spending on durable goods in the fourth quarter. The staff had assumed that those shortfalls in December were simply a consequence of the unavailability of GM cars and trucks, and that GM's problems would be overcome in the first quarter--with the result that projected increases for the first quarter had been raised. In his judgment, in order to consider the growth rate now projected for the first quarter to be reasonable, it was necessary to assume only that General Motors would produce vehicles at a high rate--not necessarily that sales to consumers would be high. Personally, he thought that GM would want its dealers to be overstocked, if anything, as the spring season approached.

Of course, Mr. Partee observed, there could be shortfalls from the staff's projections for other components, such as consumer expenditures for nonautomotive products. That did not seem more likely to him now than a month ago, in view of the relatively good retail sales recorded in the weeks just before and just after Christmas. There could also be some shortfalls in automobile sales for GM's competitors that could result in cutbacks in production schedules and hence in a somewhat smaller rise in real GNP than the staff was currently projecting. Even so, he would expect a large increase in the first quarter, mainly as a result of the post-strike catch-up.

Mr. Mitchell noted that the staff projection indicated an increase of $29 billion in dollar GNP in the first quarter. He asked how Mr. Partee would assess the probability that the rise would be much less--say, about $15 billion. In posing that question he was assuming that, within feasible limits of variation, monetary policy could no longer have much impact on first-quarter GNP.

Mr. Partee replied that in his judgment the probability of a first-quarter rise of only $15 billion was very small--perhaps about 5 per cent. It was hardly conceivable to him that the increase would not be in a range of $20 billion to $30 billion. The real question, he thought, was whether it would be closer to the lower or the higher of those figures.

Mr. Mayo asked whether full allowance had been made in the projections for the Federal pay increase.

Mr. Partee replied that the pay increase was reflected in the income figures shown, beginning with the first quarter of 1971.

He should note, however, that the personal saving rate was projected to remain at a fairly high level--7.1 per cent. It could be argued, perhaps, that the over-all saving rate would decline, and that therefore the allowance for the pay raise was not "full." In any case, an effort had been made to take the Federal pay raise into account.

Mr. Mayo then remarked that an earlier comment by Mr. Partee seemed to imply that allowance for the new depreciation guidelines would have little effect on the GNP projections for 1971. He recalled that at yesterday's news conference Chairman McCracken of the Council of Economic Advisers had indicated that the change might result in a rise of business investment of 2.5 per cent this year, rather than the 1.5 per cent shown by recent Government surveys. He asked about Mr. Partee's impression of the likely effects of the change.

Mr. Partee replied that a quick analysis, using the Board's econometric model, suggested that the change in guidelines would increase capital spending by about $1 billion in the fourth quarter of 1971--a figure broadly consistent with Mr. McCracken's comments. However, the impact of the change could be expected to grow over time, so that the effect would be greater in 1972. Those conclusions were of course preliminary; the staff would be in a position to present a more considered assessment at the next meeting.

Mr. Mayo commented that the change in depreciation guidelines might have not only direct effects on business spending but also indirect effects through its impact on confidence. While the indirect effects might not be quickly apparent in the GNP figures, they could be quite important over time.

Mr. Partee said he would certainly agree that the action represented a positive economic development. He might note that it would also serve to increase the volume of internal funds available--a consequence that might have important implications for corporate spending behavior, particularly of smaller firms.

Mr. Daane said he had three related questions concerning prices. First, how did the staff assess the general price outlook? Second, was there any real evidence of consumer resistance to price increases? Third, to what extent was the behavior of prices over coming months likely to be susceptible to the influence of monetary policy?

Mr. Partee replied that while judgments with respect to the behavior of prices were particularly difficult to make at this time, it was the staff's view that the rate of price increase would moderate gradually as the year progressed. Wholesale prices of food had been moving down and might continue downward over the months ahead as a result of supply factors, although the corn blight problem might adversely affect supplies of meat later in the year.

Prices of raw materials probably would be weakening over the whole period because of slack demands here and abroad. Finished goods prices would be affected on the one hand by buyer resistance, and on the other hand by the needs of producers to cover rising costs; the course they followed would be determined by the relative strength of those disparate influences. Clearly, the pressures of cost-push were intense--the price increases just announced by a major steel producer were only the latest indication of their magnitude. Whether monetary policy could or should try to cope with the pressure of rising costs by holding down the level of economic activity was a policy matter.

Mr. Daane then asked whether incoming data appeared to be validating the expectations of a boom in housing this year.

Mr. Partee replied that housing starts had been rising relatively rapidly. A large proportion of the recent starts were in multi-family units, where a shortage existed. How strong the market would be for single-family houses was not yet clear, however, and it probably would not be until information was available on sales during the spring.

Chairman Burns observed that downgrading seemed to be under way in the market for new homes; the average size of houses was being reduced.

Mr. Francis commented that there were reports in his District of buyer resistance to current prices of housing. Such resistance could have important consequences for the rate of single-family housing starts later in the year.

Mr. Daane asked what the probabilities seemed to be for the adoption of an incomes policy to buttress monetary and fiscal policy.

Chairman Burns commented that all one could say at this point was that the matter was being discussed actively but that no firm decisions had been taken.

Mr. Eastburn said he would like to pursue the question of prices. He noted that Mr. Partee had expressed the opinion in his earlier statement that there would be little risk in an accelerated growth in the money supply at present. He (Mr. Eastburn) agreed with the view that in the short run the main effect of rapid monetary expansion would be to reduce unemployment. However, he wondered whether the staff thought the same trade-off would prevail in the longer run.

Mr. Partee said that--with unemployment at 6 per cent and still rising, with the capacity utilization rate at 75 per cent or below, and with resources readily available throughout the country at stable prices--there seemed to be a good deal of room to stimulate the economy without expecting the additional demands to result in a price level higher than it would otherwise be. In other words, the existing slack was so great that reducing it was not likely at this point to add to inflationary pressures. What the longer-run consequences would be would depend on the rate of economic recovery; if GNP rose rapidly and unemployment dropped very sharply, conditions could be created under which sellers would ask for higher prices and even unorganized labor would ask for higher wages than otherwise. But the question of the appropriate speed of a recovery was distinct from the immediate question of whether a recovery was a desirable current objective. The answer to the latter obviously was yes; and considering the availability of resources, he thought there was considerable latitude for bringing the needed recovery about.

Mr. Francis asked what monetary assumptions underlay the staff's projections for 1971.

Mr. Partee replied that the projections assumed a 6 per cent rate of increase in the money supply through the fall of the year. He would recommend a rate of about 7 per cent for most of the year, plus an additional increase in the first quarter to make up for recent shortfalls. Presumably, at some point later on the growth rate would have to be shaded down from 7 per cent.

Mr. Swan said he was somewhat impressed by the fact that there had been a rather large expansion in liquidity recently as a result of the continuing large inflows into time deposits and thrift accounts. It seemed to him that that development reduced the significance of M_1 somewhat and increased the significance of broader monetary measures. While there might have been shortfalls in various monetary aggregates, it should be noted that those in the broader monetary measures were of considerably smaller dimensions than those in M_1. He was a little surprised that Mr. Axilrod had not made any comments on measures other than M_1 in his statement today.

Mr. Axilrod observed that he had had two sentences on the subject in an early draft of his presentation but had decided to omit them in the interest of time. The sentences were as follows: "Rates of growth in broader concepts of money, defined to include various types of financial savings accounts, also slowed in the fourth quarter, but remained fairly high and were above the rates of the second quarter of 1970. However, these rates of growth for the most part reflected the favorable return on deposit instruments as market rates declined further; and they also reflected the weakness in the economy itself, which was manifested in modest spending and a propensity to save in more protective forms."

He might add two points, Mr. Axilrod continued. One was simply to report that at the time of the previous meeting M_2 had been expected to increase at a 9.7 per cent annual rate in the fourth quarter, and it had in fact grown at a 9.2 per cent rate. Thus, Mr. Swan was quite right in observing that there had been only a minor shortfall in that measure. Secondly, at the time the staff was predicting a 5 per cent growth rate for M_1 in the fourth quarter it was also anticipating a substantial rise in over-all liquidity. But the liquidity improvement that had occurred did not seem to him to reduce the grounds for concern about the shortfall in M_1, since it was in part a reflection of weakness in the economy. Banks could increase their liquidity because there was not much loan demand; consumers were increasing their liquidity because of concern about income prospects. Data were not available on M_2 for a long enough period to permit a proper evaluation of the 9.2 per cent growth rate in the fourth quarter, but he suspected that that figure was high relative to a 3.6 per cent rate of money growth. The staff was projecting continued rapid growth in time deposits in the first quarter, but he had some reservations about that projection since it was possible that banks would be reducing the rates they offered on time deposits as the quarter progressed. Thus far they had held their deposit rates at high levels relative to market rates, apparently in order to get back to their previous competitive positions.

Mr. Maisel referred to Mr. Eastburn's question concerning the risks and benefits of a more expansionary policy and noted that he had recently looked into the implications of perhaps a dozen economic projections with that question in mind. Setting aside one or two projections that were based on purely monetarist models, they all implied so substantial a degree of resource underutilization in 1971 as to make it clear that a level of GNP at least $10 billion higher than that shown in the Board staff's projection would be welcome. The staff's projection differed from the others--correctly, in his judgment--in showing a larger increase in the deflator over the year than they did. Also, the unemployment rate for the fourth quarter indicated in the staff's projection--6.7 per cent--was higher than in the others. All of the models suggested that an addition of $10 billion in GNP would cut the unemployment rate substantially by the fourth quarter, but would still leave it relatively high--5.7 or 5.8 per cent according to the Board's model, and well over 5 per cent in the others. At the same time, all of the models indicated that the cost--measured by an additional increase in the GNP deflator over its rate at the smaller GNP--would be relatively small, perhaps 0.2 of a percentage point. Those calculations clearly supported Mr. Partee's view that there was considerable leeway for more rapid GNP growth.

Mr. Heflin remarked that 1970 had seemed to be a particularly bad year in terms of the number of work stoppages and the manhours lost--apparently the worst year in that respect since 1959. Noting that the labor situation had had a marked impact on business confidence, he asked for Mr. Partee's views about the outlook for 1971.

Mr. Partee said he certainly agreed that the labor difficulties of 1970 were very serious. Those difficulties were the product of a succession of years of rapidly rising consumer prices and of growing frustration on the part of workers concerning the lack of growth in their real take-home pay. To his mind the sources of the problem had not diminished, and so he would anticipate another difficult labor year in 1971.

Mr. Kimbrel asked whether the GNP projections for the first quarter reflected an assumption that consumers were more optimistic about progress toward the goal of curbing inflation.

Mr. Partee said the staff had not assumed much improvement in consumer attitudes in the first quarter. Attitudes had seemed to improve slightly last summer, but they had deteriorated again in the fall; and there seemed to be no reason to believe that consumers would now become more optimistic. That judgment was reflected in the staff's projection that the saving rate would be 7.1 per cent in the first quarter--almost unchanged from the 7.2 per cent rate of the preceding quarter. While people might become more optimistic later in the year, the likelihood seemed to be just as great that pessimism would grow as a result of rising unemployment and smaller increases in wages. Accordingly, no significant allowance for changes in attitudes had been made in the projections.

Mr. Coldwell asked whether the staff believed that confidence could be restored by monetary stimulation alone, without an abatement of cost-push pressures.

Mr. Partee replied that he could summarize his own view by saying that consumers would become more confident if the unemployment rate were brought down by stimulative policies--or if the rate of price advance slowed, which he thought would be consistent with policy stimulation in light of the current underutilization of resources. While business confidence might be affected by cost-push pressures, there was little that monetary policy could do to abate such pressures. On the other hand, a pickup in sales was apt to make businessmen more optimistic, even if costs were continuing to rise rapidly.

Mr. Coldwell remarked that he had heard nothing from the staff today to suggest that cost-push pressures were likely to abate. If they did not he would doubt that business confidence could be improved merely by monetary stimulation.

Mr. Galusha said it was his impression from a good deal of recent listening that consumers and workers were frightened and resentful. He agreed that a process of downgrading was under way in residential construction. He might also note that officials of a large manufacturing company with whom he had talked recently saw no indications of an upturn in orders in the reports that came in from the field.

Mr. Galusha then observed that he had been interested in Mr. Axilrod's comments today about the need for continued easing in financial markets. He asked whether Mr. Axilrod thought the prime rate was approaching an equilibrium level as a result of the several recent reductions.

Mr. Axilrod replied that, as he had indicated in his statements at other recent Committee meetings, it was his view that the real rate of return on capital in some sense had declined considerably. Consequently, he would expect interest rates in long-term markets to decline if inflationary expectations did not grow and if the money supply expanded at a reasonable rate. If inflationary expectations were to abate significantly, he thought long rates would fall rather rapidly. So far as banks were concerned, at present levels of rates in the short-term market--including rates on commercial paper--banks might have to probe a little further with the prime rate, and perhaps to engage in aggressive salesmanship, if they were to recapture customers. In addition to cutting the prime rate further, he would expect--as he had indicated earlier--that banks might begin to drop their CD rates again.

Mr. Galusha then remarked that the businessmen with whom he had spoken did not indicate any loss of enthusiasm for cost-cutting actions, involving layoffs of workers, one- and two-week furloughs, and so forth. Nor did their capital budgeting programs for the year reflect any particular degree of optimism, apart from some very general, unspecified hopes for the second half of the year. He asked whether the staff was aware of any major industrial corporations, apart from utilities, that were anticipating growth.

Mr. Partee said his contacts with business executives were undoubtedly more limited than Mr. Galusha's. However, he had noted no particular indications to that effect in the red book,[1] which included comments on all twelve Federal Reserve Districts. The economists of industrial firms with whom he had talked seemed to expect a modest recovery, but they also indicated that they were now more optimistic than management. Earlier, of course, they had been less optimistic.

Chairman Burns observed that businessmen's views on the outlook seemed to involve a lag, and Mr. Partee agreed. The latter went on to say that while cost-cutting remained a major objective of corporations, individual actions of that kind had a once-for-all character. The fact that such actions had already been so extensive might mean that a good deal of their impact was already a matter of history.

Mr. Treiber said he would like to reinforce Mr. Swan's remarks regarding liquidity developments. Although the money supply as narrowly defined did not rise as much in December as had been expected, for the year as a whole it had nevertheless risen by

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

5.5 per cent. The increase in various broad measures of liquidity--such as the narrowly defined money supply plus time deposits at commercial banks, and the narrow money supply plus all time deposits except large-denomination CD's--had been rapid in the second half and substantial in the year as a whole. In sum, he saw no reason to complain about the year's growth in the money supply, especially in the light of the large growth in other measures of liquidity.

Mr. Treiber remarked that while the demand for bank credit had been sluggish recently, demands in the capital markets remained heavy. In recent months interest rates had declined on a broad front, and money market conditions had eased greatly. Those developments should contribute to orderly credit expansion.

Mr. Robertson then observed that he had been delighted to find that the latest blue book included summary figures for changes in the money supply on various definitions. He hoped such figures would continue to be shown.

Chairman Burns expressed the view that the blue book had improved steadily over the course of the year. The text was now clearer and simpler than it had been earlier, and in his judgment it provided a highly useful focus for the Committee's deliberations.

The Chairman then called for the go-around of comments and views on monetary policy and the directive. He suggested that the discussion would be most fruitful if the Committee members concentrated on two questions. First, have recent developments with respect to the monetary aggregates and conditions in credit markets been satisfactory? Second, what targets should the Committee adopt now for the monetary aggregates and credit conditions?

He would say a few words by way of opening the discussion, Chairman Burns continued. In his judgment, the economy was now suffering chiefly from a certain weakening of confidence. Deterioration of confidence had been widespread in the business community and also among consumers. To achieve economic recovery and to contain the forces of inflation--which were still strong on the cost side--it was necessary somehow to find ways of strengthening confidence. He thought the action the Administration had announced yesterday to liberalize depreciation allowances would go some distance toward rebuilding confidence in the business community. Legislation enacted last year had imposed about $5 billion in additional taxes on corporate enterprises, and the new move would lighten the tax burden on corporations at a time when they badly needed some relief.

However, the Chairman said, that move by itself was not nearly sufficient. In his judgment, what businessmen and consumers were looking for was a convincing Government policy with respect to prices and wages. He thought such a policy would emerge in time. It might emerge much too slowly, but there was not much the System could do about that.

One thing the System could do, Chairman Burns remarked, was to strengthen the Administration's confidence in the Federal Reserve. As far as society as a whole was concerned, confidence in the Federal Reserve appeared to be strong and growing. However, the Administration's confidence in the System was weakening as a result of the shortfalls that had occurred in the rates of monetary growth. He was not concerned so much about the loss of System prestige and credibility as he was about the possible impact on other Governmental policies. In his view the Committee's recent policy decisions had been basically sound; it was in performance that the System had been falling short. The credibility of the Federal Reserve would be greatly strengthened if it became apparent that the Committee was seeking to make up the recent shortfalls. He would hope, therefore, that the members would give very serious consideration to alternative B of the draft directives.

At Chairman Burns' invitation, Mr. Treiber opened the discussion. He noted that, as he had indicated earlier, he was somewhat disappointed that growth in the narrowly defined money supply had been less than expected in December. When viewed over a longer period, however, the expansion in the money stock appeared satisfactory to him, particularly in light of the growth that had occurred in other monetary aggregates.

Mr. Treiber then made the following statement:

I am disturbed by the present sluggishness in the economy with its resultant social costs. But I am also disturbed by inflation which continues to be a major problem. Causes for concern about inflationary prospects include the cost-price pressures built into the economy by various collective bargaining agreements, the severe balance of payments deficit, and the increased questioning of the soundness of the dollar at home and abroad. We have the difficult task of steering between Scylla and Charybdis--of seeking to avoid a pounding in a whirlpool of inflation and a battering on the rocks of recession.

Some further modest easing of credit policy would seem appropriate, but I think it would be unwise to seek aggressively to promote monetary ease. We would run the risks of undercutting what progress we have made in the fight we have been waging against inflation and of further imperiling our international financial position.

Of the three draft directives suggested for consideration by the staff I would prefer alternative B. But I would suggest some revision of the first sentence of the second paragraph. I suggest that the sentence read as follows:

"To implement this policy, the Committee seeks to promote moderate growth in money, taking account of the lower growth in recent months, and to promote a further expansion in bank credit."

I would interpret such a directive as contemplating a making up of the shortfall in M_1 that apparently occurred in the fourth quarter of 1970, but I would be satisfied if only some progress was being made in that direction by the time of the February meeting. A Federal funds rate in the 4 to 4-3/4 per cent range would seem appropriate. I think that the course of bank credit is important. It is more important than something that is merely "attendant" upon the growth of money.

Mr. Francis said he was still not concerned about the shortfalls in the rate of monetary expansion--as measured by M_1--in the latter part of 1970. Since June money had increased at an annual rate of about 5 per cent; since February it had expanded at a 6 per cent rate; and since December 1969 at a rate of about 5-1/2 per cent. It seemed to him that money growth over periods of two to four quarters probably had the most relevance for spending, production, and prices, and in his judgment the money stock had been rising at an appropriate rate over recent periods of that length.

He would recommend a continuation of the 5 per cent trend rate of money expansion that had prevailed since June, Mr. Francis remarked. Projections by the staff at the St. Louis Bank indicated that such a course would produce a rate of growth in total spending of about 6-1/2 per cent over the next year and, in their opinion, a better trade-off between price and production trends over the next several years than would result from a more rapid growth rate. His staff believed that an increase in money at a rate of as much as 8 per cent would most likely produce a 9 or 10 per cent rate of growth in total spending a year from now and a rate of increase of more than 4 per cent in prices.

Of the three alternative directives submitted by the staff for Committee consideration, Mr. Francis continued, he preferred alternative A because it implied less acceleration in the rate of growth of money and because it put less emphasis on money market conditions than did the other alternatives. As he had indicated, he would prefer a smaller rate of money growth from December to March than the 6 per cent rate associated with alternative A in the blue book.

Mr. Francis felt that in implementing policy much less emphasis should be given to money market conditions. In the past three months interest rates had declined markedly and most other measures of money market conditions had eased, yet monetary expansion had slowed. He realized that in the next few weeks the Treasury would be conducting a large refunding and substantial changes in interest rates were generally believed to be undesirable during such a period. However, he felt even more strongly that "even keel" considerations should not prevent the System from providing whatever amount of monetary growth the Committee judged would result in an appropriate rate of growth in total spending.

Mr. Kimbrel indicated that in his opinion the recent behavior of the monetary aggregates had left something to be desired. He also noted that developments in the Sixth District strongly supported expressions of concern regarding the inflationary implications of current wage negotiations. Perhaps he was especially sensitive to that problem because the only unit of General Motors that had not yet reached a strike settlement was located in Atlanta. In the construction industry, recent wage settlements in Atlanta and Miami were shocking; and if the pattern of rising construction costs continued he would not be optimistic about the outlook for housing or other building activity. With regard to the question of confidence in the Federal Reserve, he had sensed a significant increase of confidence in the District because of the System's recent actions. Indeed, many appeared to be attributing more power to the Federal Reserve than it actually possessed, and they seemed to be looking mainly to the System for a solution to the nation's economic problems. The degree of confidence of both the consumer and the businessman in System policies was going to be highly important in the period ahead.

Under present circumstances, Mr. Kimbrel said, it seemed appropriate for System policy to place primary emphasis on market conditions and interest rates. He felt that the recent orderly declines in short-term interest rates had been beneficial and he would not like to see such declines reversed. Moreover, he would welcome further declines in long-term rates, although the forthcoming Treasury refunding limited what could be achieved immediately in that connection. If he had a choice, he would prefer a directive similar to that issued at the Committee's December meeting. Assuming that the analysis contained in the blue book was correct, if the Desk were guided mainly by money market conditions an appropriate growth in M_1 would be achieved. If the

Committee favored alternative B of the staff drafts he would have no objections to Mr. Treiber's proposed rewording of that alternative.

Mr. Eastburn indicated that he was primarily concerned about the longer-run effects of monetary policy, as his earlier question to Mr. Axilrod had implied. He thought the Committee's policy should be directed at curbing inflation over the longer run. To achieve that objective he believed it would be necessary to foster relatively constant growth rates in the monetary aggregates. Such an approach to policy probably would serve better than any other to enhance confidence in the System.

Mr. Eastburn added that his preference for the directive would be alternative A. The 6 per cent rate of growth in money associated with that alternative seemed to him to be consistent with the longer-run perspective he favored. He would not be overly concerned about recent shortfalls so long as the average growth rate over time was appropriate. He would be concerned, however, if the growth rate in money called for by alternative A was associated with a sizable upturn in market interest rates. To deal with that risk, he would add the following proviso clause to the staff draft: "provided, however, that if strong tendencies toward tighter money market conditions become apparent, growth in money and bank credit should be permitted temporarily to exceed targeted rates."

Chairman Burns asked how Mr. Eastburn would reconcile his interest in achieving appropriate monetary growth rates over time with his lack of concern about the recent shortfalls.

Mr. Eastburn replied that the question was, in part, a matter of the time period one had in mind. He would not favor the kinds of sharp variations in money market conditions that might be needed to keep money on the target path in the short run; he preferred to focus on quarterly targets. Also, if a deviation from the target growth rate occurred in the short run he would favor simply returning to that growth rate rather than attempting to compensate for the deviation.

Mr. MacDonald indicated that in his view the appropriate targets for the money supply and the adjusted bank credit proxy were implied in the directive adopted at the December meeting of the Committee. Therefore, he was disturbed both by the shortfall in the growth rates of those two monetary aggregates over the fourth quarter and by the implications of the current projections for the first quarter. While bank reserves had increased at the expected rate in the fourth quarter, slower growth in the money supply was apparently caused by smaller than expected increases in demand deposits, in part reflecting the continued softness in business loan demand. It seemed to him that the shortfall of nearly 1-1/2 percentage points in the money supply growth rate for the fourth quarter should be made up during the current quarter. Therefore, of the draft directives he would support alternative B, which was cast in terms of a target rate of growth of 7-1/2 per cent for the money supply and a consistent path for the adjusted bank credit proxy. Those objectives might imply significantly lower money market yields. It seemed to him that the modest "catch-up" move implied by alternative B was consistent with the Committee's desire to increase real economic activity without generating additional inflationary pressures.

Mr. Brimmer said he was generally satisfied with recent developments in credit conditions and the monetary aggregates. The performance of the bank credit proxy had been roughly in line with Committee wishes, and money market conditions seemed to have come out not too far from expectations.

With respect to the targets that should be set for the period ahead, Mr. Brimmer indicated that in general he favored the money market conditions associated with alternative B of the draft directives. He thought the Federal funds rate should center around 4-1/2 per cent and the bill rate around 4-3/8 per cent. He was disturbed, however, by the notion that alternative B was intended to make up for the shortfall in M_1 that had occurred over the fourth quarter. He did not want to see money market conditions tightened, as the blue book indicated might be required under alternative A, but at the same time he saw no need to make up for the recent shortfalls in money. He agreed with Mr. Eastburn that it would be undesirable to seek to compensate for shortfalls in the aggregates within relatively brief periods. Also, he was not very concerned about shortfalls in so narrow a measure as M_1 in a period when other monetary aggregates had increased at a relatively rapid pace.

Mr. Brimmer added, in response to Mr. Holmes' earlier inquiry, that he would not like to see the bill rate or the Federal funds rate fall below 4 per cent. In that connection, the blue book suggested that the alternative B growth rates for the aggregates would be associated with a funds rate in a range from 4 to 4-3/4 per cent.

Mr. Maisel noted that he had already made clear his view of a proper goal for the economy. He now wanted to make a number of comments on the directive. First, he believed the Committee should continue to consider movements in the monetary aggregates over longer periods than a month or two. Thus, he would have preferred that the target paths under consideration today indicate the desired April level, which in the case of alternative B would then have shown a growth rate somewhat under 7 per cent, and in alternative C a rate somewhat under 8 per cent. That contrast to the rate shown in the blue book simply underscored the obvious point that the Committee should not be overly influenced by rates of change over short periods.

In connection with Mr. Swan's comments, Mr. Maisel said, it should be noted that on the average over the past 10 years the rates of expansion in M_2 and bank credit had been about twice that in M_1. The blue book showed that in 1970 bank credit expanded relatively more slowly than in earlier years in relation to the growth in M_1. Thus, for the year 1970 M_1 had been a conservative guide to the growth in the monetary aggregates as a group. The projections for the coming period again showed bank credit expanding less relative to money than in prior years.

With respect to current policy, Mr. Maisel observed that because of even keel considerations the Committee had only this coming week to adopt a stance to be retained through the forthcoming Treasury financing. The Committee would meet again before that stance could be varied. He would have the Manager move immediately to a range for the Federal funds rate of 4 to 4-1/4 per cent. That would represent only a slight change, if any, from recent levels, and it would be in line with the staff's view of the funds rate necessary to meet the Committee's long-run objectives for the monetary aggregates. Because of the large growth expected in GNP in the current quarter, he thought little or no attention should be paid to the rates of growth in the aggregates between now and the next meeting unless they continued to fall considerably below the Committee's objectives. The models were too poor to predict accurately the impact on monetary flows of the expected temporary bulge in demand.

Mr. Maisel remarked that if the Committee accepted alternative B instead of C--and, as he had indicated, he did not think the path of the aggregates over the next four weeks was important--he believed fairness to the public would require imparting more definite information in its directive by finding a substitute for the word "moderate" in the phrase "moderate growth in money" in the second paragraph. When the Committee had first used the term "moderate" last year, it had had a goal of 3 per cent expansion in money. The word had been appropriately omitted in December when the Committee's desired rate of growth was 6 per cent.

In his judgment, Mr. Maisel continued, it was important that the Committee not return to the use of the word "moderate" since that would obscure the fact that a real change in objectives had occurred. If the Committee used a single term to encompass a change of 100 per cent in its growth rate objectives, it would be employing that term in a meaningless manner, and it would not be correctly reporting its policy. While "moderate" was a nice, innocuous word which the Committee might be reluctant to give up, it seemed important to him that the directives have a true information content. He would suggest substituting the words "moderately expansive" for "moderate."

The Chairman observed that a reference to "moderately expansive growth" would make the phrase redundant.

Mr. Maisel said he held no brief for that particular suggestion, and was open to alternatives. But it seemed to him that if the Committee had changed its policy substantially it should not continue using the same word to describe its policy.

Chairman Burns remarked that the Committee should keep Mr. Maisel's comment in mind.

Mr. Daane said he wanted to renew a plea he had made unsuccessfully during 1970--namely, for the Committee to see whether it could not find some way of retaining the advantages of increased emphasis on the monetary aggregates in its internal deliberations, while avoiding the overly narrow focus by the public and the market on a single indicator--M_1--that had been fostered by the procedures the Committee had been following since early 1970. In that connection, he was impressed by the observation in a recent staff memorandum[1/] to the effect that publication of the Committee's quarterly targets for the monetary aggregates with a time lag of only 60 days could have undesired effects on financial markets. In his judgment undue concentration on M_1 risked undesirable market reactions even with a 90-day lag. Moreover, he thought the recent concentration on M_1 had contributed to the problem of confidence in the Federal Reserve which the Chairman had mentioned. Finally, in his view

1/ This memorandum was dated November 5, 1970, and entitled "Possibility of reducing time lag in publication of FOMC policy records from 90 to 60 days."

the performance of monetary policy would have been better last year if instead of focusing so narrowly on the growth rate in M_1, given the state of projections and realization, the Committee had placed greater emphasis on money market conditions--calling for the degree of easing that appeared appropriate in light of the continuing softness of the economy.

Today, Mr. Daane observed, he would favor seeking the money market conditions described in the blue book in connection with alternative B;[1/] and, in the Committee's old parlance, he would add that the Manager should resolve doubts on the side of ease. He did not like the wording of alternative B, however, since--like all of the alternatives the staff had submitted today--it called for maintaining the bank reserves and money market conditions "consistent with" specific targets for the monetary aggregates. Since there could be no assurance that the money market conditions associated with alternative B in the blue book would in fact prove to be consistent with the aggregative targets cited, he would prefer to formulate the directive in terms of the desired money market conditions themselves.

1/ The blue book description of those conditions read as follows: "Under alternative B, the money market may have to be eased from currently prevailing conditions; the funds rate was around 4-1/2 per cent on Friday and might have to be moved down into the lower half of the 4 - 4-3/4 per cent range specified. The 3-month bill rate would likely go into a 4 - 4-5/8 per cent range, but may not drop to the lower end of the range unless the Federal funds rate falls to 4 per cent or below for a sustained period of time."

Mr. Daane added that he agreed with Mr. Maisel's observation concerning the importance of even keel considerations in the coming period. He (Mr. Daane) thought particular care was needed to make sure that appropriate account was taken of Treasury financings not only in the Committee's policy decisions but also in the way such decisions were reported in the policy record. He had been disturbed by the fact that the draft policy record for the October 20 meeting mentioned even keel considerations almost as an afterthought. In his judgment, such a denigration of the even keel concept was likely to lead market participants to infer that Treasury financings no longer offered any constraint on System operations. An undue focus on targets for M_1 was likely to lend support to the same inference. Personally, he thought some flexibility was desirable with respect to even keel, and he would not want to suggest a rigid adherence to the concept; at the same time he would not want to imply that the concept had been abandoned entirely.

Mr. Daane then asked for the Manager's views first on the risks that might be incurred if market participants concluded that the Committee had abandoned even keel considerations, and second on the relevance of the coming Treasury financing to the policy alternatives presented today.

In response to the first question, Mr. Holmes expressed the view that such a conclusion by the market would be dangerous.

In his judgment market participants understood that the Federal Reserve had a flexible approach to even keel, but they would not expect the System to ignore a major financing completely.

As to the second question, Mr. Holmes noted that according to the blue book the realization of the aggregative objectives associated with alternative A was likely to require pushing the funds rate up from its recent range around 4-1/2 per cent into a 5 to 5-3/4 per cent range. He was not sure he agreed with that judgment, but if it was correct such firming during a major Treasury financing would be highly disturbing. The money market conditions associated with alternative B generally encompassed those that had prevailed recently, and so would not be upsetting. If alternative C were adopted, the emergence of the easier money market conditions called for would tend to make the forthcoming Treasury refunding even more of a success than was currently expected.

Mr. Daane observed that Mr. Holmes' comments reinforced his view that it would be appropriate to seek the money market conditions associated with alternative B.

Mr. Mitchell indicated that he did not share Mr. Daane's nostalgia for directives formulated in terms of desired money market conditions, and he did not think the Committee was likely to return to that old-fashioned "seat-of-the-pants" approach. He agreed, however, that there was a problem of too much emphasis on the performance of M_1 as an indicator of monetary policy. The problem was compounded by the fact that some of Professor Friedman's disciples had given the monetarists' position an aura of religious dogma.

Mr. Mitchell went on to say that he was not unhappy with the policy the System had been pursuing. Unless the Committee reversed its course, he had no doubt that the results would be all that anyone could reasonably expect of monetary policy. His first choice for the directive would be alternative B as drafted by the staff, but he could also accept alternative C. He would urge the Manager to purchase more Treasury coupon issues and to pay minimal attention to even keel considerations in the period ahead. He would expect the Federal funds rate to center around 4-1/4 per cent but would not set any floor on that rate.

Mr. Mitchell observed that he saw no harm in permitting a large first-quarter rate of expansion in M_1--even larger than any of the rates being discussed today. He was not sure how strong the demand for money would be during the quarter, but he would want that demand to be accommodated. He was also in sympathy with the notion of correcting for the recent shortfalls in M_1. It was not feasible under present operating procedures to avoid shortfalls or excesses in the rate of monetary expansion, and he thought the Committee could not afford to ignore them when they occurred. However, he did not agree with Mr. Treiber's suggestion to incorporate a reference to the recent shortfall in the directive. Such a reference might imply more allegiance to M_1 than he would consider appropriate, and it was not needed since the Committee's intent could be explained adequately in the policy record prepared for today's meeting.

Mr. Heflin indicated that in his view recent developments in the monetary aggregates and in credit market conditions had not been satisfactory. He favored the objectives associated with alternative B of the draft directives, but he was not happy with the proposed wording of that alternative. He thought the Committee should accept the faster growth in the aggregates it implied only as a temporary expedient. Given the rather bearish prospects for the economy after the current quarter, he thought it was important that the Committee not allow any back-up in interest rates to develop from the expected post-strike bulge in activity. He was prepared to accept a temporary speed-up in money and credit growth if necessary to prevent such a back-up. But he was not sure that the Manager should be given an unqualified instruction to ease markets further, especially in view of the low Federal funds rates that had developed last week. He would prefer to instruct the Manager to maintain the Federal funds rate in the recent 4 to 4-3/4 per cent range and to work down to the lower end of that range if the aggregates fell short of the growth implied in alternative B. He wanted to offer some substitute wording for alternative B which, he believed, would emphasize the temporary nature of the new target for the aggregates. The wording he had in mind was as follows:

> To implement this policy, the Committee seeks to promote moderate growth in money and attendant bank credit expansion, with allowance for recent shortfalls in money growth and for prospective temporary increases in demands for transactions balances that could introduce undesired pressures on credit markets. 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 this objective, taking account of the forthcoming Treasury financing.

Mr. Heflin added that he was in complete sympathy with Chairman Burns' earlier suggestion for making up the shortfalls in the monetary aggregates, but as he had indicated he believed the higher growth rates in those aggregates should be temporary.

Mr. Clay commented that some disappointment had been experienced in economic developments in recent weeks. That had been particularly true with respect to the monetary aggregates. Nonfinancial indicators had shown diverse results, with no real basis for enthusiasm, but they had been within the range of recognized probabilities. The stage was set for the more important test of the degree of upswing in the first quarter of the year as the aftermath of the auto strike, and of the strength in the second quarter following the post-strike effects.

While the record of the narrowly defined money supply had been distinctly below projections and targets, Mr. Clay continued, those results added more concern than appeared to be warranted.

Under present circumstances, the strong flow of deposits was into the time and savings categories, and that helped substantially to explain the money supply result. The broader money supply concept including time and savings deposits also had some shortfall from projections. The same could be said of bank credit. Those misses were much more modest, however. The fact was that there had been a very strong build-up in the liquidity of both the commercial banks and other depositary financial institutions.

Mr. Clay observed that the process of readjustment toward a relatively full employment of resources necessarily would take a long time if the price inflation problem was to be dealt with adequately at the same time. The international balance of payments problem also had to be taken into consideration. The Government's expenditure program would be an important factor too. Furthermore, something was wrong in an arrangement under which added slack in employment and rising unemployment were accompanied by rapidly growing wage rates. Some changes were needed to bring about a freer response to market forces.

Mr. Clay concluded that alternative A would appear to be the best choice among the draft economic directives. The idea that it would be accompanied by rising money market rates was by no means a foregone conclusion. He would have no objection, however, to specifying a continuation of recent money market conditions. In fact, it would appear desirable to do so.

Mr. Mayo said he was in basic agreement with Mr. Daane on the dangers of pinpointing the Committee's objectives too closely, but he nevertheless was somewhat more satisfied than the latter with the results of policy from a longer-run viewpoint. He did share the disappointment others had expressed over the shortfall in the monetary aggregates that had become evident at the end of December, and with the benefit of hindsight he now wished that money market conditions had been eased somewhat earlier. The recent record seemed to be fairly consistently one of under-response to emerging developments in the aggregates, although there had been some exceptions.

Mr. Mayo noted that the alternative draft directives submitted for consideration today seemed to offer more clearly defined policy choices than usual. He favored alternative B. Adoption of alternative A would, he thought, involve a considerable risk of a back-up in interest rates and a consequent undermining of confidence in the Federal Reserve. Adoption of alternative C might also undermine confidence in the System by suggesting that it had succumbed to Administration pressure; and it might damage confidence in the economic outlook by suggesting that the Committee thought conditions had deteriorated to the point where a very large injection of funds was needed.

Mr. Mayo said he thought that the Committee had issued an appropriately worded directive at its December meeting, but that not enough weight had been given in its implementation to the proviso clause relating to the monetary aggregates. One reason for the December shortfall might have been over-concern with the lower limit of the range for the Federal funds rate that had been given in the previous blue book. With respect to the coming period, he would have no objection to a reduction in the Federal funds rate to 3-3/4 per cent--or even to 3-1/2 per cent--if that proved necessary to achieve alternative B objectives for the aggregates, provided it did not produce disorderly market conditions.

Mr. Galusha indicated that he was quite delighted about the restoration of liquidity that was under way. The fact that banks were again buying municipal securities was likely to be reflected in an accelerated rate of spending by State and local governments. Banks also were increasing their efforts to make loans, which was a wholly desirable development under present circumstances.

However, Mr. Galusha continued, he was not satisfied with the System's recent performance. In particular, he was distressed by the shortfalls in the monetary aggregates. Whether the problem was one of wrong goals, wrong models, or wrong procedures, the Committee was not accomplishing what it had set out to do.

Mr. Galusha observed that he favored alternative B for the directive. He shared the misgivings expressed by others about alternative C in light of the timing problem. He also shared some of Mr. Daane's nostalgia with regard to the use of money market conditions in the directive. However, he thought that the course of the monetary aggregates was important, and that it was appropriate for the Committee to make substantial use of aggregative measures in its framework for policy formulation.

Mr. Swan indicated that he was quite satisfied with recent developments in the flows of funds and money market conditions. And, as he had indicated earlier, he was not particularly concerned about the recent shortfall in M_1 in view of the growth rates recorded in the broader measures of money and bank credit. Moreover, it was not clear that much could have been done about the December shortfall since it had not become evident until late in the month. The recent experience offered another illustration of the Committee's long-standing problems with respect to both projections and current measurements of the monetary aggregates. What might be done about those problems was not at all clear.

Mr. Swan said he would favor accommodating the expansion in money which might occur as a result of the expected rise in economic activity in the first quarter, but he would not want to follow the procedure Mr. Axilrod had recommended of encouraging such an increase. As to the draft directives, he noted that according to the blue book alternative A might involve a tightening in money market conditions. He certainly would not want such tightening to take place at this point. Mr. Eastburn's suggestion for adding a proviso clause to alternative A was helpful in that respect, but if such a proviso were to be adopted he would prefer to eliminate the word "strong" from the clause reading "if strong tendencies toward tighter money market conditions become apparent." He could accept alternative B for the directive, but he was a little concerned about its seemingly open-ended association with easier money market conditions. In his view such easing would not necessarily be required; he would prefer to see the Federal funds rate and the bill rate in ranges somewhere between those associated with alternatives A and B in the blue book.1/ In his judgment there also was merit in the directive proposals of Mr. Heflin and Mr. Treiber, although he would not want to include a reference to the shortfalls in the monetary aggregates.

Mr. Coldwell said he agreed with much of what had been said during the discussion today. He thought the credibility of the Government's anti-inflationary efforts had suffered because the general public was interpreting recent decisions in the area of Federal spending as stimulative moves that disregarded the inflation cost. It was his impression that people still had some confidence in the Federal Reserve. However, the System's credibility

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1/ According to the blue book, realization of the alternative A targets for the aggregates might involve a Federal funds rate in a 5 to 5-3/4 per cent range and a bill rate moving up to 5-1/4 per cent. Under alternative B it was thought that the Federal funds rate might have to be moved down into the lower half of a 4 to 4-3/4 per cent range and the bill rate would likely go into a 4 to 4-5/8 per cent range.

had also suffered in the sense that questions were being raised as to how far it was willing to go in its efforts to restimulate the economy. In his view policymakers were facing a critical problem of confidence on the part of businessmen and consumers. He suspected that it was up to the System to provide some of the leadership that was needed, but in light of the wage-cost problem it was clear that the Federal Reserve could not accomplish all that some people expected of it at this juncture.

Mr. Coldwell observed that he agreed with Mr. Daane that the System was faced with a real problem because of an unduly narrow focus on short-run changes in the money supply. In his (Mr. Coldwell's) judgment the recent movement toward lower levels of interest rates might have been smoother if the Committee had focused on money market conditions, calling for the easing of such conditions and the resolution of doubts on the side of ease. The issue of whether to make up for shortfalls in the money supply might well become academic if the System remained as impotent as it apparently was during the final months of 1970 in achieving its money supply objectives. While he was not satisfied with recent developments in the monetary aggregates, it was primarily because of the worrisome nature of the conditions causing the shortfall.

As for current policy targets, Mr. Coldwell continued, he would aim for a slow but steady easing of money market conditions, with further reductions in the discount rate and a minimal provision of new reserves. He thought net free reserves might be in a range of $100 million to $300 million, the Federal funds rate in a range of 4 to 4-1/2 per cent, and the bill rate in a 4-1/2 to 5 per cent range. He would not favor placing an absolute floor on the Federal funds rate, but would hope that it would not have to go below 4 per cent. He would expect such money market conditions to be associated with a growth rate of around 5-1/2 or 6 per cent in the money supply over the first quarter. However, he would not be disturbed if the growth rate came out above or below the target path for a month or two, since he was more concerned about money supply growth on a quarterly basis than on a monthly basis.

Mr. Morris remarked that in his judgment the basic reason for the repeated shortfalls in M_1 was the fact that the strength in the economy had been consistently overestimated since midsummer. During that period the Manager had regularly achieved the money market conditions outlined in the blue book and, in fact, had permitted easier conditions to develop at times. Those conditions had not been compatible with the Committee's targets for money supply growth because the economy had proved weaker than anticipated. He was concerned about the shortfall in M_1 principally because of the economic weakness it reflected. The shortfall in the economy--relative to what the Committee had anticipated six months ago--was considerable.

Mr. Morris went on to say that the key to economic expansion in 1971 would be a set of financial conditions that would produce a substantial increase in the flows of funds to the mortgage market and to State and local governments. In his judgment such conditions would require further declines in short-term money rates, and he thought the Committee should aim for such declines. In that light alternative B seemed to be the appropriate directive. He did not think it was particularly important whether the 7-1/2 per cent growth rate in money associated with alternative B was looked upon as making up for earlier shortfalls or as indicative of a more expansionary monetary policy. In view of the weakness in the economy, however, it was important to achieve the faster rate of growth in money called for by B.

Mr. Morris said he was concerned about the possibility that the 4 to 4-3/4 per cent range for the Federal funds rate associated with alternative B in the blue book might not prove compatible with a 7-1/2 per cent rate of expansion in M_1 over the first quarter. It should be recognized that the staff was basing its analysis of money market conditions and monetary aggregates on a projected gain of around $30 billion in GNP in the first quarter. He seriously doubted that GNP would accelerate that rapidly. Accordingly, he thought the Manager should be prepared to push the Federal funds rate below 4 per cent--to 3-1/2 per cent or to whatever level proved necessary to keep M_1 on a 7-1/2 per cent growth path. It was his hope that the Committee would give the Manager an instruction to that effect. Otherwise, he feared the stage would have been set for another shortfall in money.

Mr. Robertson said he did not think anyone around the table could be satisfied with the results of the monetary policy pursued over the past two years. He then made the following statement:

> When it comes to the economic outlook, I find myself a little more optimistic than the staff. Retail sales at the end of the Christmas season were a little stronger than the staff had forecast. Furthermore, the latest figures on price developments show a little less upthrust than before. However, I am aware that unemployment is rising, and spiraling wage rates are continuing to plague us. We are still a long way from the satisfactory resolution of our economic problems, and in the absence of help from the Administration in the form of an incomes policy it is going to take longer to resolve them.
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> In these circumstances, monetary policy still has to tread a very cautious and narrow path. I believe a continued moderately expansive policy is what is called for; not one so expansive as to bring about a resurgence of inflationary psychology and fuel the fires of inflation, but one that is sufficient to provide an ample flow of funds to the capital markets, including mortgage and State and local government markets, and to foster a generally comfortable condition throughout money and credit markets as a whole. I believe my purposes could be achieved by maintaining about the prevailing money market conditions, a posture which would allow some further drop in longer-term rates but preclude any backing up from present levels.
>
> I do not endorse this course because of a desire to see a certain pattern in M_1 growth. I recognize the shortfall in M_1 that developed in the fourth quarter, but I doubt the wisdom of trying to make that up in view of December's favorable performance of M_2 and other even more inclusive measures of money.
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> As I said at the last meeting, I think we ought to be paying more attention to these broader monetary aggregates in judging the longer-range effectiveness of our

policies. In particular, I believe that in present circumstances these broader aggregates are more closely related than the narrow one to the achievement of the kind of accommodative conditions fostering expansion of State, local, and mortgage credit, which I regard as an important economic objective.

In terms of instructions to the Manager, I am not enthusiastic about any of the alternative directives presented to us. I would hesitate to vote for alternative A if it involves, as the staff indicates, pushing the Federal funds rate up from its present trading range. On the other hand, I would be reluctant to vote for a target rate of growth of M_1 in the 7-1/2 per cent to 8-1/2 per cent range, called for by alternatives B and C, even if I had more confidence than I do in the validity of the target or our ability to hit it. Consequently, I would prefer to vote for a directive that called for the maintenance of prevailing money market conditions, with a proviso that care should be exercised to avoid a significant shortfall in the expected rates of growth in money and bank credit. To be specific, I would propose a second paragraph reading as follows:

"To implement this policy, the Committee seeks to promote accommodative conditions in credit markets and moderately expansive growth in monetary and credit aggregates. Taking account of the forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing money market conditions, except as changes become needed to counter financial developments which deviate significantly from the aforementioned objectives."

Chairman Burns said he might add a word on the subject of credibility. It was important that System officials never lose sight of the fact that the Federal Reserve was a part of the Government, and that whatever the Federal Reserve did or failed to do would have an influence on the actions of the Administration and the Congress. He had good reason to think that the fiscal policy now being developed in the Executive Branch was being influenced by certain interpretations which Administration officials were making--rightly or wrongly--of System policy. He had defended that policy to the best of his ability, but there was a limit to what one could do in defending the unwanted results of a policy.

Personally, the Chairman remarked, he had been greatly disturbed by the shortfalls of the monetary aggregates from the Committee's targets, at a time when economic conditions were deteriorating--with production slumping, unemployment rising, and expectations about a recovery being repeatedly frustrated. Under such circumstances it was particularly difficult to defend a slowing of growth in money from the rates prevailing earlier in 1970.

For such reasons, Chairman Burns said, he was strongly in favor of the policy course called for by alternative B of the draft directives. A majority of the members had indicated a similar preference during the go-around. However, from the large number of language modifications that had been proposed he concluded that many members shared Mr. Robertson's lack of enthusiasm for the specific wording of the staff's draft.

He might note, the Chairman continued, that he had difficulty in seeing the advantages of the modification suggested by Mr. Treiber. In particular, he would not favor the addition of a reference to the lower rate of growth in money in recent months nor would he want to delete from the statement of the Committee's objectives the language calling for some easing of conditions in credit markets. With respect to the latter, he thought that easier credit conditions would be needed not only to help achieve the Committee's targets for the monetary aggregates but also were necessary to promote economic recovery and thus an important monetary policy objective in their own right.

Mr. Treiber commented that he would prefer to see an easing of conditions only if required to achieve the targets for the aggregates. He had formulated his proposal for the second paragraph with that thought in mind.

In reply to a question by Mr. Coldwell, Mr. Holland indicated that the phrase "credit market conditions" was intended to encompass conditions in intermediate- and long-term debt markets as well as those in the money market.

Mr. Maisel said he would favor including a reference to easing credit market conditions in the directive. He also thought that the Manager should be instructed to move immediately toward somewhat easier money market conditions in order to get the monetary aggregates on the target path associated with alternative B. He would not be overly concerned if the aggregates grew at faster rates, but if they appeared to be falling short he thought the money market should be eased to the extent consistent with even keel. He would not favor setting any lower limit to the Federal funds rate.

The Chairman asked whether all of the Committee members would indicate their preference with regard to the inclusion in the directive of the reference to easing of conditions in credit markets that was shown in alternative B. Five members favored the inclusion and five were opposed. Mr. Francis observed that he had not indicated a preference because he did not plan to vote for alternative B in any event.

Chairman Burns then suggested that the Committee instead might consider language calling for the promotion of "accommodative conditions in credit markets," as in the first sentence of Mr. Robertson's proposal for the second paragraph. He noted that the sentence in question went on to call for "moderately expansive growth in monetary and credit aggregates." In view of the redundancy of "moderately expansive growth" it might be better to substitute "moderate expansion."

The Chairman noted that there was also a substantive difference between Mr. Robertson's sentence and the first sentence of alternative B, in that the former referred to "monetary and credit aggregates" and the latter called for "moderate growth in money and attendant bank credit expansion." He asked for an indication of the members' preferences between those formulations.

A majority of members expressed a preference for a formulation reading "moderate expansion in monetary and credit aggregates."

The Chairman then proposed that the Committee consider a second paragraph with the first sentence along the lines proposed by Mr. Robertson and the second sentence as shown in alternative B. Specifically, such a directive would read as follows:

> To implement this policy, the Committee seeks to promote accommodative conditions in credit markets and moderate expansion in monetary and credit aggregates. 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 those objectives, taking account of the forthcoming Treasury financing.

Mr. Mitchell said it might be useful for the Manager to indicate how he would interpret the proposed directive language.

Mr. Holmes commented that he would interpret the phrase "accommodative conditions in credit markets" as calling for resisting any tendency for intermediate- and long-term market interest rates to back up, but not resisting any tendencies for them to decline. As he understood it, the aggregative growth rates desired were those associated in the blue book with alternative B. He would note, however, that he was not sure about the Committee's intent with respect to the Federal funds rate. The members had expressed a broad variety of views on that question -- ranging from permitting the rate to fall to whatever levels might be necessary to achieve the aggregative targets, to maintaining about the recent levels unless there was a back-up in longer-term rates.

Chairman Burns said the choice appeared to be between maintaining the prevailing 4-1/2 per cent Federal funds rate at least at the beginning of the coming period or moving it downward immediately in the interests of achieving the Committee's targets for the monetary aggregates. He favored the latter course; to wait for new information on the aggregates before considering whether to lower the funds rate would make it difficult to achieve the target growth rates, particularly since only a short period would elapse before the Treasury financing would become a consideration.

Mr. Mitchell remarked that in his judgment the Committee was paying too much attention to even keel considerations. He thought that such considerations had been over-emphasized in the past, and that they were likely to be even less important than usual in connection with the forthcoming Treasury financing.

Mr. Daane commented that, as he had indicated earlier, he believed some flexibility was desirable in the matter; and at present he favored moving toward ease to the extent feasible in light of the Treasury financing. However, he would not want to take a one-sided approach, observing even keel constraints in periods of firming but ignoring them completely in easing periods.

Mr. Mitchell replied that he also would not favor such an approach. His point was simply that the Committee did not have to view Treasury financings as constituting as significant a restraint on operations as it had in fact tended to do.

Mr. Daane then noted that under alternative B the blue book suggested moving the funds rate down into the lower half of a 4 to 4-3/4 per cent range. Like the Chairman, he would favor reducing the funds rate immediately--not specifically to achieve a 7-1/2 per cent growth rate for M_1 in the first quarter, although he would have no objection to such a growth rate--but because he thought some easing of money market conditions was desirable at present.

Mr. Mitchell observed that those who had spoken in favor of reducing the funds rate had formulated their statements in two different ways. Some preferred a rate centering on 4-1/4 per cent, but were willing to have it go a little below 4 per cent if necessary to attain the aggregative objectives; others had suggested that the rate should be reduced to whatever level might be required for that purpose. He would be highly reluctant to issue an instruction of the latter type to the Manager.

Mr. Francis remarked that in his judgment the Manager should have the flexibility necessary to accomplish the Committee's objectives for the aggregates. He thought the Committee was exaggerating the importance of the Federal funds rate, and he saw no objection to a rate of, say, 3-3/4 per cent, if that was found to be needed.

Mr. Brimmer said he had modified his earlier views on the appropriate Federal funds rate in light of the subsequent discussion. He would now favor aiming immediately for a rate centering on 4-1/4 per cent, and he would hope that it would not be necessary to go below 4 per cent. At the same time, he would want to rule out the possibility during the coming period of a funds rate as low as 3 or 3-1/2 per cent.

Chairman Burns asked whether there would be any strong objection to aiming immediately for a funds rate centered on 4-1/4 per cent, with the understanding that the rate should be moved down within a 3-3/4 to 4-3/4 per cent range if the aggregates appeared to be falling short of the target paths.

No members indicated that they objected.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft for the first paragraph and the language he had read for the second paragraph.

> With Mr. Francis dissenting, 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 output of goods and services declined in the fourth quarter of 1970, largely as a consequence of the recent strike in the automobile industry. Unemployment increased further in December. The resumption of higher automobile production is expected to result in a bulge in activity in early 1971. Wage rates generally are continuing to rise at a rapid pace, but gains in productivity appear to be slowing the increase in unit labor costs. The rise in both wholesale and consumer prices appears to have moderated recently, following substantial increases earlier in the fall. Most market interest rates turned down again in recent days, and Federal Reserve discount rates were reduced by an additional one-quarter of a percentage point. Demands for funds in capital markets have continued heavy, but business loan demands at banks remain weak. Although growth in the money supply accelerated in December, over the fourth quarter as a whole it was at a rate below that prevailing in the preceding three quarters.

Banks made substantial further additions to their holdings of securities in December, and bank credit increased sharply. The foreign trade surplus has declined markedly in recent months. The over-all balance of payments deficit on the liquidity basis in the fourth quarter was apparently about as large as in the third quarter. The deficit on the official settlements basis was very large as banks continued to repay Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to promote accommodative conditions in credit markets and moderate expansion in monetary and credit aggregates. 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 those objectives, taking account of the forthcoming Treasury financing.

The meeting then recessed and reconvened at 2:25 p.m. with the same attendance as at the morning session.

Chairman Burns called for discussion of the Euro-dollar problem, noting that two staff memoranda had been distributed regarding a possible Federal Reserve program of matched sale-purchase transactions to help moderate repayments of Euro-dollar liabilities by U.S. banks.[1/] He asked Mr. Solomon to open the discussion.

1/ These were a memorandum from the Committee's General Counsel, dated January 8, 1971, and entitled, "Legality of matched sale-purchase transactions to induce banks to retain Euro-dollar holdings," and a memorandum from the Board's Division of International Finance, dated January 11, 1971, and entitled "Euro-dollar problem: Federal Reserve matched sale-purchase transactions." Copies of both memoranda have been placed in the files of the Committee.

Mr. Solomon noted that there had been extended discussions of the Euro-dollar problems at recent Committee meetings. Also, a memorandum of his[1] that had been distributed to the Committee on December 9, 1970, outlined the nature of the problem, commented on the potential for further outflows of Euro-dollars, and discussed the possible consequences of lack of official action to stem the outflow. He would not comment at length on those matters today, but it was worth repeating his observation of this morning that the official settlements deficit for 1970 now appeared likely to be between $10 billion and $11 billion. It was impossible to say what further outflows would occur in 1971 in the absence of official action, but they might be on the order of $4 - 5 billion. If so, the official settlements deficit in 1971 might reach the level of $8 billion or more.

There were two main reasons for concern over such a prospect, Mr. Solomon continued. The first was the possibility that outflows of that magnitude would trigger heavy speculation against the dollar and lead to an atmosphere of crisis in the foreign exchange markets. Secondly, even if there were no crisis, continued heavy outflows of Euro-dollars could result in serious

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1/ This memorandum, originally addressed to the Board of Governors and dated November 17, 1970, was entitled "Dealing with the Overhang of Euro-dollar Liabilities: Laissez-faire vs. Taking Action to Discourage Outflows."

difficulties in the international financial relations of the United States. The outflows from this country were tending to undermine the monetary policies of other countries, and were adding to foreign official holdings of dollars. Moreover, the prospects for continued creation of SDR's might be greatly damaged if the United States incurred an official settlements deficit on the order of $18 billion in the first two years following their activation. This country had pressed for the SDR arrangements, and the concurrence of other countries had been based on the expectation that the U.S. deficit would be quite small.

Mr. Solomon remarked that such concerns had led to a search for techniques to limit if not stop the Euro-dollar outflow. The essence of the problem was that short-term interest rates in the United States were low relative to those in the Euro-dollar market, as a result both of the easing of monetary conditions here and of the continued heavy demands for Euro-dollars abroad, notably from Germany. That rate disparity made it expensive for American banks to retain their Euro-dollar liabilities. As the Committee knew, U.S. banks had been repaying such liabilities, although for various reasons a number of them had not gone below their reserve-free bases.

In general, Mr. Solomon observed, there were two kinds of techniques that might be used to cope with the problem. The first was to offer U.S. banks an inducement to retain their expensive Euro-dollar liabilities, in effect by sharing part of the additional cost the banks incurred by not replacing them with domestic liabilities such as CD's. The second was to absorb the excess funds flowing into the Euro-dollar market as a result of U.S. bank repayments, with the objective of keeping those funds from flowing into foreign central bank reserves. The proposal before the Committee today, for a Federal Reserve program of matched sale-purchase transactions, was of the first variety. The Treasury Department and the Export-Import Bank were now considering the possibility of an issue by the Export-Import Bank of securities to be sold to American banks for the account of their foreign branches, which would absorb about $1 billion of the banks' liabilities to their branches. It was quite likely that such a security issue would be announced later this week. If so, that would be a first step in attempting to deal with the problem. It was possible that a second issue by the Export-Import Bank would follow. Also, since there were limits on what that Bank could do in this connection, the Treasury was examining the possibility of issuing such securities directly, but he did not know what decision might be reached.

In essence, Mr. Solomon continued, the proposal for Federal Reserve matched sale-purchase transactions, like that for an Export-Import Bank security issue, was designed to offer U. S. banks an asset sufficiently attractive to induce them to hold onto their

Euro-dollar liabilities. The System could make the MSP agreements with head offices of U.S. banks at interest rates equal to or slightly above the cost of one-month Euro-dollars, so that the head office would be holding an asset with a yield comparable to the cost its branch was incurring on its Euro-dollar deposits of comparable maturity. Or, at the option of the bank, the System could make the MSP agreement with the branch, in effect taking over the branch claim on the head office. In that case, the branch would be using the proceeds of repayments by the head office to enter into MSP's with the System, and the effects would be the same.

The MSP program could be used in a flexible way, Mr. Solomon observed. The staff memorandum suggested an initial authorization of $1-1/4 billion of MSP's with one-month maturities. The amount could be modified according to the need, and the whole program could be phased out quite rapidly if the need disappeared. Also, the yields offered could be raised or lowered with changes in the differential between short-term interest rates in the United States and in the Euro-dollar market. There was, in effect, a trade-off between the yields offered and the amount of MSP's issued; since the objective would be to provide banks with a return sufficient to induce them to hold onto their Euro-dollar liabilities, the larger the proportion of such liabilities that were covered by MSP's the lower the yield would have to be, and vice versa. In any event, it would not be necessary fully to cover the excess costs of maintaining Euro-dollar liabilities, because the banks did attach some importance to preserving their reserve-free bases.

Mr. Solomon said it was perhaps unnecessary for him to pursue the technical details of the proposal, since the staff memorandum dated yesterday discussed the relation of MSP's to requirement-free bases, the method of allocation, and the questions of pricing and amounts to be issued. It was perhaps worth noting, however, that each dollar of MSP's issued would absorb a dollar of reserves, so that offsetting open market operations presumably would be called for.

Chairman Burns observed that while members of the Board had had some prior discussions of the MSP proposal, the Reserve Bank Presidents had been apprised of the details by means of the staff memorandum distributed only yesterday. Accordingly, he thought it would not be appropriate to call for a Committee decision on the proposal today. It would be desirable, however, to have a preliminary discussion for the purpose of clarifying the underlying issues, since circumstances might well require action by the Committee soon--perhaps by telegraphic vote or in a telephone conference meeting. As the staff memorandum suggested, if the members were favorably inclined toward the proposal the most efficient procedure might be for the Committee to amend the continuing authority directive to specify certain general criteria for MSP's and to delegate responsibility for making decisions on matters of detail to a subcommittee.

The Chairman remarked that it might be helpful if he were to outline the general approach to the problem that the Board had been discussing recently, even though there were a great many uncertainties at this stage. As indicated by Mr. Solomon, the Export-Import Bank security might be issued this week and the Treasury might then put out a similar issue of its own, but that was by no means certain. In the thinking of Board members, the MSP plan represented a possible subsequent step. The Board had also discussed an alternative form of System action involving changes in reserve requirements, but a majority of the members were inclined toward the MSP approach. While the broad objective was, of course, to limit the flow of dollars to foreign central banks, the Board was not necessarily unanimous on the question of how sharply that flow should be limited; some members had indicated that they would welcome a certain amount of erosion in the liabilities of American banks to their branches. He personally would like to see those liabilities vanish, but not too speedily. In any case it was important that the System, along with other

Government agencies, be in a position to act promptly and effectively on the matter should the need arise.

Chairman Burns then suggested that before proceeding further the Committee should hear the views of the Special Manager.

Mr. Coombs said he could give only a preliminary reaction since the staff's memorandum had reached him only this morning. He thought it would be highly desirable for the Export-Import Bank to take the first step. There was a risk of an adverse market reaction to any operation of this type, but that risk might be least for an Exim operation in view of the precedents that existed--for example, in transactions of the Italian official agencies.

The Chairman asked Mr. Coombs to elaborate on the nature of the adverse reaction he feared.

Mr. Coombs said the announcement that such an operation was being undertaken might lead to considerable discussion as to how far it would go, and that could have some speculative effects. As a result, there could be upward pressures on Euro-dollar rates in the maturity ranges utilized. Indeed, it was possible that the operation would be self-defeating; Euro-dollar rates might rise enough to offset whatever added incentive was being offered to U.S. banks to retain their Euro-dollar liabilities. In his judgment that risk would be greater in connection with a U.S. Treasury issue than an Exim issue, since the former was likely to attract more attention. He was thinking particularly of domestic reactions; to foreigners the question of which U.S. agency was involved might matter little. The proposed Federal Reserve operation would represent a considerable departure from past practice, and he found it quite difficult to formulate an immediate judgment of its possible effects.

Mr. Coombs added that operations of this general type might also arouse suspicions that the United States considered the approach as a possible means of financing its balance of payments deficits on a longer-run basis. Any such suspicions, of course, would not help to encourage confidence in the dollar.

In concluding, Mr. Coombs said he would like to have an opportunity to consider the general subject further. In response to an inquiry by the Chairman, he indicated that he would forward a memorandum on the subject to the Committee as soon as possible.

Mr. Solomon remarked that an announcement of the Exim issue no doubt would have some effects on Euro-dollar rates of the type Mr. Coombs had described. For purposes of clarification, however, it might be worth noting that the Export-Import Bank would not be floating its securities in the market; it would be selling them to branches of American banks which in turn would pay for them with claims they already had on their head offices.

Thus, there would be no absorption of funds from the Euro-dollar market; there would simply be a shift of foreign branch claims from their head offices to the Export-Import Bank. The potential return flow to the Euro-dollar market would be reduced, and that would tend to make Euro-dollar rates higher than they otherwise would be; but, of course, the whole objective of the proposed operations was to limit the flows from the United States to the Euro-dollar market.

In reply to a question by Mr. Daane, Mr. Coombs said he thought the European central banks would welcome any actions the U.S. authorities might take to moderate the reflow of Euro-dollars. His earlier comments had been concerned with possible reactions by market participants, as distinct from those of central bankers.

Mr. Coldwell asked whether the MSP program might make Euro-dollar liabilities attractive enough to U.S. banks to encourage banks not now in that market to begin borrowing Euro-dollars.

Mr. Solomon replied that that was theoretically possible, but not likely to be significant in practice. Banks with present liabilities equal to or greater than their reserve-free bases would have to meet a 20 per cent reserve requirement on any increases in those liabilities. Under the latest Board regulations, banks that had been using minimum bases equal to 3 per cent of deposits would be able to borrow Euro-dollars and so establish "historical" bases until January 20, 1971, and the borrowings of some such banks might be influenced by the existence of an MSP program. However, the program would be calculated to relieve banks of some of the excess costs of Euro-dollar liabilities--not to make such liabilities highly profitable.

Mr. Coldwell then asked whether the MSP's would not be sufficiently attractive to lead to complaints about inequitable treatment of small banks relative to large banks.

Mr. Solomon replied that while the great bulk of Euro-dollar liabilities were held by large banks, any small banks with such liabilities would be eligible to participate.

In reply to questions by Messrs. Treiber and Mayo, Chairman Burns said the thinking was in terms of a sequence of actions, with the Export-Import Bank moving first. The System would act later, if at all, and only after there had been a chance to observe the response to the Export-Import Bank action. The Bank's decision to issue securities would not be dependent in any way on the System's plans.

Mr. Treiber expressed the view that a sequential approach was highly desirable. In his judgment the problem was basically the Treasury's responsibility. He would hope that the Exim operation would be followed by a corresponding operation by the Treasury itself. The System might best serve in a backstop capacity, standing ready to take part if necessary to help prevent a crisis.

Chairman Burns agreed that the Treasury had final responsibility in the matter. However, if for whatever reason the Treasury was not in a position to discharge that responsibility, the Federal Reserve should stand ready to meet its own responsibilities. He had been urging Treasury officials to act in the sequence following the Exim issue. At the same time, he had some sympathy for their problems in this period of transition, with the present Secretary about to leave office and his successor named but not yet installed.

Mr. Robertson asked what limits existed on the volume of securities the Export-Import Bank might sell.

Chairman Burns replied that the Export-Import Bank had outstanding debt to the Treasury of about $1.5 billion, which could be repaid with the proceeds of security issues. Beyond that, the Exim Bank had some loans in its portfolio that might possibly be sold to banks.

In response to the Chairman's request for comment, Mr. Holmes said the proposed MSP operation seemed to him to be feasible from a technical standpoint. It would, of course, pose some problems. Thus, as Mr. Solomon had noted earlier, each dollar of MSP's entered into would reduce member bank reserves by a dollar. Unless by chance reserve absorption happened to be desired at the time, it would be necessary to offset that effect by other operations. Such problems, however, were by no means insurmountable. The Desk was prepared to act quickly if the Committee decided to put the program into effect.

Mr. Mitchell asked whether it would be feasible to employ an auction technique for selling the proposed MSP's to banks having Euro-dollar liabilities.

Mr. Holmes said he thought such a technique would seriously damage the effectiveness of the program in limiting Euro-dollar outflows, because the lowest bids probably would be submitted by banks most likely to retain their Euro-dollar liabilities in any case. Thus, the added incentive to retain such liabilities would be provided to the very banks that needed it least.

Following some further discussion of technical aspects of the MSP program and its possible effects, Mr. Coldwell expressed the view that the proposal amounted to putting another patch on an important problem area. Such a patchwork approach had been used for some time in the past and in his judgment it had inhibited the kind of fundamental action that was needed. He thought that in appraising the proposal it would be useful for Committee members to consider the response that should be made if the System were requested to provide similar assistance in connection with, say, the domestic housing market.

Chairman Burns asked whether Mr. Coldwell meant to suggest that the Federal Reserve could take some fundamental action in the balance of payments area.

Mr. Coldwell replied that the System could not do much of a fundamental nature in that area. His concern was that the kinds of actions the Federal Reserve had been taking might be reducing the incentive of other policy makers to take needed measures.

Chairman Burns remarked that while the proposed program might be described as patchwork, he doubted that it would have any effect one way or the other on the attitudes of Government officials towards the balance of payments problem.

Mr. Brimmer observed that over the years the Committee had held consistently to the view that the Federal Reserve was not the proper institution to provide long-term financing for the U.S. balance of payments deficit. He was concerned about the risk that the Federal Reserve might find itself unintentionally performing that function if it undertook the proposed MSP program. He agreed with the view that the primary responsibility for dealing with the problem of Euro-dollar reflows lay with the Treasury.

Mr. Mitchell expressed the opinion that the proposed program was not patchwork. In his judgment it was a useful means of helping to preserve the existing international money market; the alternative might well be the destruction of that market. He thought the Federal Reserve had some responsibility in connection with the Euro-dollar market and, more generally, in connection with the U.S. balance of payments problem. The System had developed its swap network as one means of discharging the latter responsibility. He had raised as many questions about the swap network as any other Committee member, but he still regarded it as contributing something more than a short-run solution to the underlying problem.

Mr. Maisel remarked that central banks had traditionally been concerned with the differential between foreign and domestic interest rates. He thought the MSP proposal could be viewed as one means of allowing adjustments in those rates to proceed more gradually than they otherwise would, and of allowing the flows induced by the rate differentials to take place more gradually than otherwise. Such objectives, he believed, were quite appropriate for the Federal Reserve. The situation would be very different if it were proposed that the System should keep MSP's outstanding indefinitely.

Mr. Brimmer said he agreed with the principle Mr. Maisel had expressed. However, Mr. Maisel was assuming that the Federal Reserve would not in fact find itself keeping MSP's outstanding indefinitely. He (Mr. Brimmer) would favor an approach under which it was assured that that would not be the case. In that connection he noted the arrangements that had been made in the past for the Treasury to take over any System swap debt that was running on for too long.

Mr. Daane expressed the view that the Federal Reserve had a legitimate concern with the problem posed by the potentially large further outflows of Euro-dollars, particularly since those flows were highly disturbing to foreign countries and might provoke undesirable reactions on their part. He thought the sequence of steps the Chairman had described earlier was the right approach, and that the System should now put itself in a position to act promptly if and when the need arose. He also agreed that it would be desirable for the Committee to delegate to a subcommittee the responsibility for making operating decisions in order to achieve the kind of flexibility that would be needed.

Mr. Maisel referred to Mr. Brimmer's comment about the risk that the Federal Reserve might find itself engaged in long-term financing, and indicated that he would hope that any MSP transactions the System undertook would not remain outstanding for more than a year, except perhaps under highly unusual circumstances.

Chairman Burns said he would hope that the program could be terminated within six months or a year. However, he could not state with confidence that that would be the case; he did not have enough information at present to say how long it might prove necessary to live with the program.

Mr. Maisel remarked that an expectation that the MSP's could remain outstanding for more than a year would put the whole matter in a different context.

Mr. Brimmer commented that the duration of the program should be approached as a policy question, and Mr. Maisel agreed.

Mr. Eastburn asked about the status of the alternative approach to the problem that had been mentioned, involving adjustments in reserve requirements.

Chairman Burns observed that work on the reserve requirement approach was continuing on a contingency planning basis. As he had indicated earlier, a majority of the Board favored the MSP approach. He shared the majority's preference partly because whatever incentive was provided to banks to retain their Euro-dollar liabilities by adjustments in reserve requirements could be nullified very quickly by shifts in international interest rate relationships. In short, he was not sure the reserve requirement approach offered sufficient flexibility to insure that the objective would be accomplished.

Mr. Daane remarked that the reserve requirement approach also might be more likely than the MSP proposal to lead to requests of the sort Mr. Coldwell had mentioned--for the System to use similar techniques to aid such sectors as housing. Nevertheless, he thought it was desirable to keep the reserve requirement proposal in view as a possible alternative.

Mr. Brimmer observed that he would prefer the reserve requirement approach.

Mr. Swan commented that he would not be sanguine about the possibility of terminating the MSP program within a short period, or of holding its scale down to the initial level. He would feel better able to evaluate the MSP proposal if he was familiar with the details of the reserve requirement alternative.

The Chairman asked Mr. Solomon to summarize the reserve requirement plan.

Mr. Solomon said the objective of the plan remained that of providing banks with an incentive to retain their Euro-dollar liabilities by reducing the excess cost those liabilities involved. The essence of the proposal was that a bank with Euro-dollar liabilities would be permitted a reduction in its percentage reserve requirements on demand deposits to the extent the latter were matched by Euro-dollar liabilities. For example, a bank with $300 million of Euro-dollar liabilities might be permitted a reduction of 10 percentage points--from 17-1/2 to 7-1/2 per cent--on an equivalent volume of demand deposits. The saving to the bank would be equal to about 40 basis points on its Euro-dollar liabilities. A number of variants of the plan had been discussed, including one in which a change of the type he had described would be combined with a general cut in reserve requirements.

The Chairman observed that all the various plans were still under consideration. He agreed with the view that the reserve requirement approach should be kept in mind for possible use at a later stage.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, February 9, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

January 11, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on January 12, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services declined in the fourth quarter of 1970, largely as a consequence of the recent strike in the automobile industry. Unemployment increased further in December. The resumption of higher automobile production is expected to result in a bulge in activity in early 1971. Wage rates generally are continuing to rise at a rapid pace, but gains in productivity appear to be slowing the increase in unit labor costs. The rise in both wholesale and consumer prices appears to have moderated recently, following substantial increases earlier in the fall. Most market interest rates turned down again in recent days, and Federal Reserve discount rates were reduced by an additional one-quarter of a percentage point. Demands for funds in capital markets have continued heavy, but business loan demands at banks remain weak. Although growth in the money supply accelerated in December, over the fourth quarter as a whole it was at a rate below that prevailing in the preceding three quarters. Banks made substantial further additions to their holdings of securities in December, and bank credit increased sharply. The foreign trade surplus has declined markedly in recent months. The over-all balance of payments deficit on the liquidity basis in the fourth quarter was apparently about as large as in the third quarter. The deficit on the official settlements basis was very large as banks continued to repay Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee seeks to promote moderate growth in money and attendant bank credit expansion 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 those objectives, taking account of the forthcoming Treasury financing.

Alternative B

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion. 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 those objectives, taking account of the forthcoming Treasury financing.

Alternative C

To implement this policy, the Committee seeks to promote easing of conditions in credit markets and more rapid growth in money, with attendant bank credit expansion, 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 those objectives, taking account of the forthcoming Treasury financing.