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, October 19, 1971, at 9:30 a.m. As indicated below, only a limited number of staff members were in attendance during the first part of the meeting.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Clay
Mr. Kimbrel
Mr. Maisel
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Coldwell, Eastburn, Swan, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Francis and MacLaury, Presidents of the Federal Reserve Banks of St. Louis and Minneapolis, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Axilrod and Hersey, Associate Economists
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors

Mr. Black, First Vice President, Federal Reserve Bank of Richmond
Mr. Sternlight, Vice President, Federal Reserve Bank of New York

Chairman Burns observed that, as the Committee members may have heard, Mr. Hugh Leach, former President of the Federal Reserve Bank of Richmond, had died in an automobile accident over the weekend. Mr. Leach had retired in 1961 after serving for 25 years--longer than any other man--as President of a Reserve Bank and as a participant in the deliberations of the Open Market Committee.

The Chairman said he knew the Committee would wish to extend its sympathies to the members of the family. At his suggestion those present stood for a moment of silence in memory of Mr. Leach.

Chairman Burns then remarked that he had thought it would be desirable to inform the members about the new Committee on Interest and Dividends and to answer any questions concerning it that they might have. For that purpose, he had suggested that the Open Market Committee hold the present limited session before turning to its regular business today.

Mr. Burns noted that the Committee on Interest and Dividends, of which he was Chairman, also included the Secretaries of the Treasury, Commerce, and Housing and Urban Development and the Chairmen of the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board. It had met once thus far, a week ago today. At the opening of that meeting he had expressed the view that attempts to regulate interest rates were fraught with danger, and that great care would have to be taken to avoid damaging the economy. Much of the discussion at the meeting had been concerned with the language of a proposed Executive Order establishing the various boards, commissions, and committees under the post-freeze economic policy. He had suggested that the draft language relating to the work of the Committee on Interest and Dividends be revised to read "The Committee shall, subject to review by the Council, formulate and execute a program for obtaining voluntary restraint on interest rates and dividends." The suggestion was intended in part to avoid implying a commitment to "stabilize" interest rates in the sense of permitting no fluctuations; as he had noted at the meeting, interest rates might have to move up for the good of the economy, or they might be forced down by market conditions. The suggested language also was intended to avoid the risk of appearing to put monetary policy functions under the Cost of Living Council. The other members of the Committee on Interest and Dividends had agreed fully on those points.

Chairman Burns observed that the new Committee also had worked out a suggested revision of a proposed amendment to the

Economic Stabilization Act and had agreed that the suggestion should be sent to the Office of Management and Budget. The existing Act at the point in question read as follows: "The President is authorized to issue such orders and regulations as he may deem appropriate to stabilize prices, wages, and salaries at levels not less than those prevailing on May 25, 1970." The purpose of the amendment was to add a clause relating to interest and dividends; in the form the Committee had suggested, the clause would read, "and to stabilize interest rates and dividends at levels consonant with orderly economic growth." Again, the thought was that under changing circumstances the appropriate level of interest rates might move up or down.

The Chairman said he might conclude with a few general observations. First, there was no sentiment within the Committee on Interest and Dividends for a program of mandatory controls; the members unanimously favored a voluntary approach. Secondly, in his judgment there was no danger that the new Committee would seek to trespass on the authority of the Federal Reserve in the area of monetary policy. Third, in the unlikely event that a decision were made to peg one or more categories of interest rates, the Federal Reserve would still have the responsibility for determining the supply of bank reserves and therefore the rates of growth of the monetary aggregates. Of course, if interest rates were pegged they could no longer perform their normal function of rationing credit, and other ways of rationing would have to be used more extensively. Finally, he should note that the Reserve Banks would undoubtedly be asked to give some assistance to the new Committee. He could not yet say precisely what kind of assistance would be needed, but it might be in connection with surveys of interest rates or with monitoring the activities of banks and other lending institutions.

Mr. Coldwell observed that several problems had been encountered in the Board's recent post-freeze interest rate survey that might have been avoided if the Reserve Banks had been consulted. He hoped the same situation would not arise in any surveys that might be done for the Committee on Interest and Dividends.

Mr. Partee remarked that in the survey mentioned by Mr. Coldwell the basic source of difficulty had been the urgency of the need for current data at the Board. Hopefully, the deadlines on any future surveys would permit Board staff to consult with their counterparts at the Reserve Banks and generally to follow more orderly procedures.

Mr. Brimmer noted that the Board members working with the staff on the survey in question had discussed the alternatives of conducting the survey directly from Washington or through the Reserve Banks. They had decided in favor of the first alternative after two questions were raised. The first was whether it would be feasible for the Conference of Reserve Bank Presidents to respond with the speed the situation demanded. The second was whether there would not be advantages in making a sharp distinction between this survey and the regular statistical programs of the Federal Reserve.

With respect to the first question, Mr. Coldwell said he thought the Presidents' Conference could have cleared the survey without introducing an undesirable delay.

After some discussion of the second question, Mr. Clay expressed the view that the need for distinguishing particular surveys from others normally could be met adequately by including appropriate explanations in the letter transmitting the questionnaire.

Mr. Robertson asked whether the Reserve Banks would be in a position to conduct surveys of nonbank lending institutions in their Districts.

Mr. Coldwell responded that such surveys could involve a sizable effort, in view of the large number of nonbank institutions. However, the effort would be no greater for the Banks than for the Board, and the Banks would have certain advantages in carrying it out.

In reply to a question by Mr. Mayo, Chairman Burns said the new Committee had not yet decided on the course it would follow with respect to dividends. In general, he thought it would be much less difficult to deal with dividends than with interest rates. The Cost of Living Council had already developed some experience in connection with dividends and had encountered relatively few problems.

Mr. Winn asked whether it would be realistic to suggest that there was much room for interest rates to move up under present circumstances.

Chairman Burns replied that he would not expect the Committee on Interest and Dividends to take any position with respect to market interest rates; indeed, it was hard to imagine any serious attempt to freeze such rates. However, the new Committee might well decide that it was desirable to launch an extensive educational campaign regarding administered rates. Administered rates, of course, tended to be relatively steady in any case. Moreover, to the extent that the Government's anti-inflationary program was successful, powerful forces tending to push interest rates to lower levels would come into play.

Mr. Kimbrel noted that interest rates had indeed been under downward pressure recently. He asked whether a problem might not arise in coming months if a change in economic conditions resulted in renewed upward pressures.

The Chairman replied that the new Committee planned to discuss that question at its next meeting. Meanwhile, he would appreciate any advice that the members of the Open Market Committee might have to offer.

Mr. Brimmer asked whether Federal Reserve Bank discount rates would be considered to be administered rates in the context of the Chairman's comment.

Chairman Burns observed that both the Board and the Reserve Banks would have to cope with the question of the discount rate in the period ahead. He found it difficult to predict anything except his own attitude; personally, he would do everything possible to preserve the System's freedom of action. In that connection, he wanted to emphasize again that there had been no suggestion in the discussions of the Committee on Interest and Dividends that there should be any interference with the System's responsibility in the area of bank reserves and monetary aggregates. He thought it was fair to say that, if that responsibility were diminished, it would be done only by act of Congress.

Mr. Coldwell said he understood that the Board had been discussing a possible revision of Regulation Q a few months ago. He asked whether the revision was still under active consideration.

Chairman Burns replied that it was not.

The following persons then entered the meeting:

Mr. Bernard, Assistant Secretary
Messrs. Eisenmenger, Gramley, Scheld, Taylor, and Tow, Associate Economists

Mr. Altmann, Assistant Secretary, Office of the Secretary, 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. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

Messrs. Link, Parthemos, Andersen, and Craven, Senior Vice Presidents, Federal Reserve Banks of New York, Richmond, St. Louis, and San Francisco, respectively
Messrs. Boehne, Hocter, and Green, Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Sandberg, Securities Trading Officer, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee held on August 24 and September 21, 1971, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee on August 24 and September 21, 1971, were accepted.

Mr. Hersey presented the following report:

I will report briefly on the present state of international discussions, on recent balance of payments developments, and on the business cycle outlook in Europe.

Governor Daane and Mr. Solomon are today accompanying Under Secretary Volcker at meetings in Paris. The atmosphere for negotiations was considerably improved by the Group of Ten finance ministers' and central bank governors' communique of September 26, and by speeches and a resolution adopted at the Annual Meeting of the International Monetary Fund in the following week. The G-10 communique reported agreement as to what are the immediate issues for negotiation and reaffirmed an instruction for the Deputies to explore the problems of longer-term reform. A key point in the communique was the mention, as an issue to be solved, of "the method" as well as the magnitude of a realignment of currencies. In view of the psychological and political importance of the gold price question in Europe, European officials regarded this as a very helpful insertion. The IMF meeting then went on to demonstrate a consensus with regard to three important points: some sizable changes in exchange parities are needed; some greater flexibility of rates will be needed thereafter; and the international reserve system of the future must give chief place to the SDR rather than either gold or the dollar. It was particularly useful to have questions of the international reserve system brought forward as a matter of priority for discussion; the United States, as well as other countries, before finally agreeing to any new set of currency parities, will need to have some answers to a number of very difficult questions about convertibility and future reserve operations.

In the meantime, market exchange rates continue to be influenced by a variety of forces, including market efforts to guess the results of future negotiations. The present structure of rates leaves a good deal to be desired. While the German mark and Swiss franc stand at 10 per cent above the pars against the dollar that were in effect until May of this year, the French franc is still very close to par and the Japanese yen, which ought to rise the most, has moved up only to 9 per cent above par.

Continuing increases in foreign official reserve claims on the United States--which amounted to $1-1/2 billion in the month of September and about the same from mid-September to mid-October--show, of course, that some central banks have been intervening to hold rates down. Reserve accruals of this magnitude are in excess of the underlying rate of the U.S. payments deficit and suggest, therefore, that speculative and hedging movements out of the dollar into other currencies have not ended.

Last week Germany and Italy reduced their central bank rates on rediscounts and advances, but Britain did not. These actions (and inaction) are to a great extent explainable by the responsiveness of the authorities in the various countries to conditions developing in their domestic economies. In addition, now that Euro-dollar rates have fallen back, a decline in German market rates helps to ease upward pressure on the exchange rate for the German mark--the present level of which, combined with the U.S. surcharge and job development credit, makes German exporters very unhappy. But with regard to general economic conditions: in Germany and Italy, where business capital expenditures have been leveling off, real growth is slowing. In Germany, it is pretty clear that the authorities have the fiscal and monetary powers needed to prevent a recession from developing, and now that the cost push from wages is rapidly easing, we think that they will be prepared to use those powers if necessary. In Britain, where the economy had been very sluggish for nearly three years, the first result of the July easing of tax and consumer credit restrictions was an almost explosive burst of buying of consumer durables. A further monetary policy move was therefore not urgent.

Our staff judgment is that Europe is not on the edge of a general recession, as some European spokesmen have said they feared it might be. But a period of very slow growth in Germany is surely ahead. Japan, too, will be going through a very difficult readjustment period.

It is quite probable that economic conditions and policies will together tend to put downward pressure on European interest rates in the next twelve months--even in Britain, where government long-term bond yields approached 10 per cent at the end of last year and now are down only to 8-1/2 per cent. A decline in European longer-term interest rates, if it comes, would be a healthy development from our point of view, since it would tend to facilitate U.S. corporate borrowing abroad after speculation against the dollar comes to an end, and to that extent--and perhaps in other ways also--would tend to reduce demands on our capital market.

Chairman Burns noted that several members of the Committee had attended the IMF meetings. He asked whether Mr. Hayes, Mr. Brimmer, or others would like to report their impressions.

Mr. Hayes said he agreed with Mr. Hersey that the atmosphere at the meetings was better than it had been some weeks earlier--no doubt in large part because of the immediately preceding meeting of the G-10 ministers. On the whole, the discussions were quite amicable. Nevertheless, the basic issues were still unresolved, and the gaps between the positions of the United States and most major European countries were large. He could not say that he came away with a high degree of optimism about the prospects for an early resolution of the differences.

Mr. Brimmer observed that during and after the IMF meetings he had spent a good deal of time with representatives of several developing countries in Africa and Asia. Those countries were concerned about the possibility that their interests would be overlooked in a settlement reached by the major nations.

Chairman Burns noted that Messrs. Daane, Mitchell, and he had met with finance ministers and central bankers of Latin American countries, who had expressed a similar concern. The Latin Americans had been told not only that their interests would be considered but also that they would have an opportunity to speak on their own behalf before final decisions were taken. He thought the effort to reassure them had been fairly successful, and he asked whether Mr. Mitchell agreed.

Mr. Mitchell said that was his impression also. It was worth noting that the Latin Americans had indicated that they prized nothing more than a strong dollar, and that whatever steps the United States took to strengthen the dollar would be to their advantage.

Mr. Hayes observed that subsequent to the meeting he had talked with the chief financial officials of Mexico. In their view, Mexico's position had been particularly endangered by the United States import surcharge.

Mr. Brimmer said he might report to the Committee the results of some rough calculations of the consequence of recent movements in exchange rates for the position of the dollar and the current account of the U.S. balance of payments. According to the calculations, the dollar had depreciated against all other currencies taken together by an amount in the neighborhood of 3 per cent. However, the currencies of some other industrial countries--including France and Italy--also had depreciated on that basis, even though they had appreciated against the dollar taken alone. It appeared that the amounts of appreciation thus far of those currencies that had appreciated in relation to all others were not sufficient to produce the $13 billion swing in current accounts that the Administration had taken as its goal. The current account swing for the appreciating countries was more likely to be of the magnitude the OECD had said was needed--about $8 billion over a two-year period. However, the United States would not have the full benefit of that swing, since present exchange rates would tend to increase the current account balances of France and Italy and also of countries outside the OECD. He would not place any great stress on the specific estimates produced by the calculations, but he thought the general conclusions were rather disturbing.

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 September 21 through October 13, 1971, and a supplemental report covering the period October 14 through 18, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said the exchange market atmosphere remained apprehensive, with most traders staying very close to shore. He had the impression that market uncertainties were also having a depressing effect on trade and investment decisions generally. Perhaps the only healthy development had been the gradual upward drift of the Japanese yen towards more realistic levels. On the other hand, the question of appropriate European exchange parities was becoming increasingly controversial. In particular, the question of cross rates among European currencies might prove to be an even thornier problem than that of rates against the dollar.

Among the real factors in the market, Mr. Coombs remarked, it was his impression that U.S. exports were being reasonably well sustained, while new orders by U.S. importers seemed to be falling off fairly sharply. The surcharge had been intended, of course, to have just that effect. The depressing effect of the surcharge on new import orders was probably being strongly reinforced by a swingback from abnormally heavy import orders placed earlier in the year in anticipation of both exchange rate instability and the U.S. dock strikes. An offsetting contraction of import orders below normal levels was under way now, and that could well result in an improvement in the trade figures later in the year and into the early months of 1972. On the trade side, therefore, the balance in the exchange markets probably was tending to shift in favor of the dollar.

On the capital side, Mr. Coombs observed, foreign investment in the U.S. stock market continued to hover around the zero mark, reflecting not only the recent declines in stock prices but also exchange rate uncertainties. As far as short-term capital flows were concerned, however, the interest arbitrage outflows that had proved so costly to the United States early in the year had apparently tapered off, and they might soon be succeeded by return flows of short-term funds not only from Japan but, more particularly, from Western Europe. Over the past few weeks there had been a flood of predictions of business recessions in Western Europe. Recessions might or might not materialize, but most European central banks meanwhile seemed inclined to take precautionary measures in the way of discount rate cuts and other easing of monetary restraints. Easing action had already been taken by the British, German, Italian, Dutch, and Belgian central banks; and he would not be surprised to see a fairly generalized downturn of European interest rates before year-end. Declines in European interest rates could bring about a sizable liquidation of earlier European dollar borrowing, thereby lending additional strength to dollar rates in the exchange markets over the next few months. In that area, much depended on the promised action of the German Government to induce some liquidation of German corporate borrowing abroad; such borrowing now amounted to nearly $10 billion, or roughly 50 per cent of the reserves of the German Federal Bank. If, in fact, heavy German debt repayments got under way, the mark would probably come under selling pressure, with sympathetic effects on the guilder, Belgian franc, and Swiss franc.

Beyond those real market factors of trade and interest arbitrage, Mr. Coombs continued, there remained the matter of the enormous short position in dollars built up by leads and lags and other speculative forces over the last six months or so. If exchange rates were realigned tomorrow at levels the market took to be plausible, he thought one could expect a massive reflow of speculative money--perhaps of the order of $10 to $15 billion--which would drive down European currency rates to whatever new floors had been established. As the Committee might recall, in the fourth quarter of 1969 the Germans experienced an outflow of $5 billion after they had revalued the mark.

A more difficult question, Mr. Coombs said, was whether--in the absence of a formal realignment--a de facto stabilization of rates might lead to at least a partial reversal of the flight from the dollar. Since the IMF meetings, the appreciation of European currencies had, in fact, shown some signs of topping off; the Bank of England and the German Federal Bank, for example, hardly had to intervene over the past week. There had been little evidence so far of a closing out of speculative positions. Nevertheless, recurrent rumors that the United States might ultimately concede an increase in the gold price of at least 5 or 6 per cent were probably tending to provide speculative support for the spot guilder and Belgian franc at premiums around that level; and sterling might also have moved up to a 5 or 6 per cent premium in the absence of Bank of England intervention over the past two months. Similarly, the forward rate on the Swiss franc worked out between 5 and 6 per cent. So long as the gold price remained an unresolved issue, earlier speculation against the dollar might be slow to reverse itself.

With respect to operations, Mr. Coombs reported that the Federal Reserve had been asked by the Belgian National Bank to repay a swap drawing of $35 million that had been on the books for seven months as of October 12, on the understanding that the Belgians would not object to the System's acquisition in the market of the Belgian francs needed. The System's market purchases had pushed the premium on the franc up from 5.5 per cent to 6.4 per cent, and the Federal Reserve had incurred an over-all loss of $1.9 million on the transaction. It was clear, however, that the U.S. Treasury vastly preferred such financial losses to the alternative of settling the swap debt with U.S. reserve assets.

Meanwhile, Mr. Coombs continued, the System was again accumulating Belgian francs--it had acquired $14 million through yesterday against further maturities totaling $25 million due on October 26 and 27, on which the Belgian National Bank had again requested repayment. It remained to be seen how much further the Account might be able to go in acquiring through the market the Belgian francs needed to settle subsequent swap maturities. He had the impression, however, that the Belgian franc might have been dragged up by the guilder, to which it was pegged by a cross-rate arrangement, to a level somewhat higher than the underlying flow of transactions would justify. In effect, the franc was a bit soft at current levels. In any event, the Belgian franc market seemed to involve a special situation which clearly did not apply to markets for other currencies in which the Federal Reserve had swap debts outstanding. For example, both the Swiss National Bank and the Bank of England had specifically asked the System not to build up balances in their currencies in anticipation of swap maturities. In those cases, however, he would expect no difficulty in securing renewals of the maturing debt.

Mr. Maisel asked whether Mr. Coombs had any impression of the net cost to speculators of holding their positions.

Mr. Coombs said he suspected that the cost was not abnormally high, since most of the speculative positions probably were financed through the Euro-dollar market and rates in that market had been coming down recently. In any case, he thought the basic consideration leading to a large potential return flow was that a great deal of money now was away from its natural home. For example, some $2 billion was locked up in Switzerland at the moment in forms that earned very little interest. Those funds would come back if the owners were given a reasonable inducement. As he had indicated earlier, a formal realignment of exchange rates probably would be followed by an enormous return flow. Short of that, a *de facto* stabilization of rates or a resolution of the gold price issue could also bring about some return flow.

Mr. Brimmer referred to Mr. Coombs' comments about repayment of the System's Belgian franc drawings, and asked whether it would not be desirable for the Federal Reserve to begin to acquire other foreign currencies in the market with a view to liquidating all of its outstanding swap drawings as they matured. Among other things, that would save carrying costs on the present swap debt.

Mr. Coombs replied that the over-all cost to the System probably would be increased, rather than reduced, by such a course, because the purchases of foreign currencies at the necessary pace would tend to drive up exchange rates. Beyond that, he thought the Federal Reserve should give appropriate weight to the wishes of its swap line partners in matters of this sort. Thus far the System had been working in harmony with its partners. An all-out effort to clear up the swap debt without regard to the consequences for exchange rates could do a good deal of damage to international relations.

Mr. Maisel asked whether it was correct to say that the Belgians wanted the System to repay its outstanding drawings to the extent it could acquire the needed currencies without unduly affecting the exchange rate for the franc, and that they were prepared to renew drawings otherwise.

Mr. Coombs responded affirmatively. He added that those two procedures appeared to be the only practical alternatives. He would not anticipate any difficulties so long as the System continued to operate in consultation with the foreign central bank concerned.

By unanimous vote, the System open market transactions in foreign currencies during the period September 21 through October 18, 1971, were approved, ratified, and confirmed.

Mr. Coombs noted that ten System swap drawings on the National Bank of Belgium, totaling $445 million, would mature in the period from November 3 through November 26, 1971--some for the second or third time. Since the System had been making active use of the Belgian line for more than one year, express action by the Committee was required if the drawings were to be renewed. He recommended that renewals for further periods of three months be authorized.

> By unanimous vote, renewal of the ten System drawings on the National Bank of Belgium maturing in the period November 3-26, 1971, was authorized.

Mr. Coombs then reported that a number of other System drawings would mature soon. These included three drawings on the German Federal Bank, totaling $60 million, maturing for the second time on November 5; three drawings on the Swiss National Bank maturing for the first or second time in the period from November 10 through November 19; and a $750 million drawing on the Bank of England maturing for the first time on November 17. Also, two drawings on the Bank for International Settlements--one for $600 million in Swiss francs and one for $35 million in Belgian francs--would mature for the first time on November 12 and 18, respectively. In all of those cases the swap lines had been in continuous use for less than one year. He recommended renewal of the drawings in question.

Renewal of System drawings on the German Federal Bank, the Swiss National Bank, the Bank of England, and the Bank for International Settlements maturing in the period November 5-19, 1971, was noted without objection.

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

Mr. Partee made the following statement:

There are various, though still partial, indications that the underlying trend of business has strengthened in the last month or so. The outstanding performer continues to be new car sales, which have been at the highest rates of the year since the mid-August announcement of the price freeze and prospective excise tax rebate. Housing starts also remain very strong, despite a decline in September. The third-quarter starts rate, at more than 2.1 million, was at a new all-time high, and building permit volume has been well maintained throughout the quarter. Nonfarm employment rose 300,000 in September, by far the largest increase for any month this year. And new durable goods orders in August--the latest data available--rose by a substantial 4 per cent, if the primary metals and volatile defense goods sectors are excluded.

So far, the pick-up has not shown up in the broader measures of activity. The industrial production index in September increased only modestly, and for the third quarter as a whole it declined 5 per cent, annual rate, from the second quarter. Third-quarter GNP figures, which will be released later this week, are expected to show only a relatively moderate gain from the second quarter, on the order of $15 billion or so. In both cases, the setback relative to the second quarter mainly reflects the inventory liquidation in steel. But the prospects now for more vigorous expansion in both GNP and production seem highly favorable. Total retail sales in September were already running at a rate appreciably above the third-quarter average. And steel output appears to have suffered its maximum decline. More generally, inventory accumulation continued very moderate in most lines throughout the summer, and inventory/sales ratios declined further. A general attempt to rebuild stocks could thus commence at any time. And the net trade balance, which appears to have been highly unfavorable for the third quarter, must be about as negative as it is going to get--considering that the surcharge is now beginning to bite.

Hence we continue to project a marked resurgence in real economic growth beginning in the fourth quarter and extending through the second quarter of next year--which is as far as our projection goes at present. Indeed, we have strengthened somewhat the projection as compared with four weeks ago. Real GNP is now expected to grow at an average rate of 7.3 per cent over the next three quarters--versus 7.0 per cent in our previous projection--reflecting the assumption that the large military pay increase recently enacted will commence in mid-November and that personal income tax reductions will be larger than the President requested, as per the House bill. As before, the pattern of recovery foreseen is that consumption will increase markedly during the remainder of this year and into 1972, that this improvement in consumer demand will stimulate a resurgence in inventory accumulation, and that better markets generally--along with the investment tax credit--will subsequently bring an upturn in business fixed investment.

The first plank of this structure--a surge in new car sales with a resulting depletion in dealer stocks--is now in place, though auto manufacturers have yet to step up their production schedules. Steel inventories are being reduced rapidly--more rapidly than after the 1968 labor settlement--which should hasten the turn-around in this sector. And the first survey of plant and equipment spending intentions for 1972 that I have seen--by Lionel Edie & Company--shows a surprisingly large 8 per cent increase in manufacturers' plans. But much of the general strengthening in markets that we anticipate remains yet to be realized, and whether it in fact develops depends critically on the state of consumer and business confidence.

The wage-price restraint program, which is an important factor in that confidence, is now at an awkward stage in its development. The novelty of the freeze is wearing off, only the general outlines of the Phase II program have been revealed, organized labor has publicly won the concessions demanded for cooperation, and serious doubts are being voiced as to how well--if at all--an incomes policy will work under the pressures generated in our large and highly complex economy. Businessmen are concerned that the Pay Board will be liberal and the Price Commission tough, so that their profits may be squeezed. Workers are concerned that wages may be limited effectively, but not prices, so that they will suffer. And to top it all off there are several major labor contracts--notably for West and East Coast dockworkers and in coal mining--that seem certain to involve settlements, at the very beginning of Phase II, far larger than could be permitted by any conceivable general guideline.

Perhaps the whole effort will founder, immediately or within a matter of months. But I think that there is more going for the program than is generally recognized. First, there is widespread public support for an end to inflation, and this should strengthen the hands of those on the Board and Commission who will press for effective restraints. Second, if the increase in real activity that we are projecting comes about, productivity could increase significantly--perhaps dramatically so, in view of the cost reforms introduced over the past year or so--substantially offsetting the inevitable increase in average employee compensation. Businesses may also be hesitant to test the degree to which higher prices would impinge on improved market conditions, especially if their aggregate profits are moving up in any event as a result of expanding volume. Finally, continued relatively high unemployment may at last be serving to moderate effective wage demands. The rise in average hourly earnings in the private non-farm economy, adjusted for compositional shifts, appears to have slowed appreciably over the summer months.

Thus, economic forces should complement the workings of the wage-price restraint program, increasing its chances of success. We are projecting that the rise in the private GNP deflator will slow to around a 3 per cent annual rate in the first half of 1972. Even with a moderating price component, the increase in nominal GNP would be very large--above 10 per cent, annual rate--if the resurgence projected in real economic activity actually materializes. And the rate of resource utilization, though improving noticeably, would still remain below optimum levels. Our projections, as of the second quarter, still show an unemployment rate of 5-1/2 per cent and factory utilization rates only a little above 76 per cent.

If the economy should develop along these highly favorable lines, what would be the most appropriate course for monetary policy? On the one hand, rapid GNP growth would be exerting a pull on monetary expansion, which might well result in higher interest rates if it is resisted. At the same time, however, the levels of resource utilization envisioned would not seem to call for more restrictive monetary conditions, especially in an environment of moderating inflation. To approximate a general impression of the problem that policy may face, we have forced our large econometric model to simulate GNP numbers like those in the judgmental projection. The result, according to the model, is that money supply would have to rise at about an 8 per cent rate in order to hold interest rates roughly unchanged through the first half of next year.

It seems to me possible that the model is overstating the expansion in money necessary to produce a stable interest rate structure in the projected recovery period. Over the spring and summer there was an unexplained bulge in money, perhaps reflecting demands for unusual precautionary balances, that may now be in process of liquidation. It is also generally agreed that interest rate levels had included an inflationary premium, which has been reduced since mid-August and may well decline further to the extent that inflation actually subsides. Nevertheless, the sharpness of the projected GNP expansion does suggest the need for sizable monetary expansion if upward rate pressures--and a possible constriction in mortgage and municipal markets--are to be avoided in early 1972. I believe that the Committee should begin setting the stage now for a resumption of faster monetary growth, as represented by expansion of the money supply at around a 6 per cent annual rate. The blue book[1/] analysis indicates that this is likely to

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

> require somewhat easier money market conditions, which I would favor moving toward promptly, prior to the upcoming Treasury refunding.

Chairman Burns then called for a general discussion of the economic situation and outlook.

In response to a question by Mr. Brimmer, Mr. Partee said the simulation analysis with the econometric model did not yield any information on probable price developments; in making the simulations, both real GNP and the deflator had been assumed to follow the paths projected under the judgmental process. He added that the econometric model, given the same monetary and fiscal assumptions, would not have produced a rate of growth in real consumer spending--and thus in real GNP--as high as the judgmental forecast. The staff projection assumed an increasing degree of consumer confidence based on reasonable success in combating inflation, which were factors the model could not take into account.

In reply to a question by Mr. Mitchell, Mr. Partee said no explicit assumption had been made in the analysis regarding the rate of money turnover. However, a gradual increase in the income velocity of money was implied, since a 10 per cent rate of expansion in nominal GNP through the second quarter of 1972 was associated with an 8 per cent growth rate in the money supply.

Mr. Mitchell observed that the recent very large quarter-to-quarter changes in turnover had led him to lose confidence in projections of the money supply. In that connection, he noted that the staff was projecting an upturn in the rate of expansion of M_1 in the first quarter of next year but very little growth in the fourth quarter of 1971. He asked whether Mr. Partee was saying in effect that sluggish growth in money in the fourth quarter was acceptable, or that it was too late to do anything about the fourth-quarter rate.

Mr. Partee responded that it should still be possible to have some effect on the fourth-quarter growth rate of money, as suggested by the blue book projections showing somewhat different growth rates under the alternatives involving different money market conditions. However, it probably would be difficult to have a large effect, since the quarter was already half over and since the money supply responded with a lag to changes in money market conditions. With respect to the recent large changes in turnover, he noted that for reasons not fully understood the money supply had grown considerably faster than expected over the spring and early summer. The factors accounting for that rapid growth might now be working in reverse, so that lower than normal growth might be anticipated for a time. That was one consideration underlying his view that the conclusion of the simulation analysis--that M_1 would have to grow at a rate of 8 per cent to hold long-term interest rates roughly unchanged in the first half of 1972--might well be an overstatement. Also, it was likely that the model did not take full account of the possible reduction in the inflation premium component of interest rates. However, if expansion in economic activity picked up as projected, he thought a slow rate of growth in money could not persist for long without generating upward pressures on interest rates.

Mr. Black said he was surprised that the automobile manufacturers had not raised scheduled production in response to the increase in sales that had occurred. He asked whether the industry had doubts about the persistence of the recent strength in demand.

Mr. Partee responded that the industry might well be uncertain as to whether underlying demand had strengthened substantially or whether current sales of 1972 models--which were at 1971 prices under the 90-day freeze--were being borrowed from the future. The industry was particularly cost-conscious at present because of the rollback of announced price increases, and he understood that it was quite costly to step up the rate of auto production--whether it was done by working the present labor force longer hours and hence incurring the expense of overtime pay, or by expanding the work force and experiencing the temporary reduction in productivity associated with the several shifts of worker assignments that were required under union rules when each new man was hired. Accordingly, the manufacturers seemed hesitant to raise output until they were certain that that was required by the faster pace of sales.

Mr. Hayes observed that the Phase II policy seemed to have been well received, and he thought there was a real chance of reducing the rate of inflation to 3 per cent per year and the rate of unemployment to 5 per cent by late 1972. If those objectives were to be attained, however, the wage board and price commission would have to follow reasonably tough policies and achieve a high degree of compliance. Moreover, real growth would have to be fast enough to yield sizable gains in productivity and employment but not so fast as to rekindle demand-pull inflation. Thus, it was far from clear that the goals would be met.

The appraisal of the outlook by the New York Bank staff generally paralleled that of the Board's staff, Mr. Hayes continued. However, his staff was a little less optimistic with respect to both real output and prices; the New York projections involved rates of increase in real output about 1 percentage point lower, and in the deflator 1 percentage point higher, than those made at the Board.

Mr. Hayes commented that his conversations with businessmen had revealed a paradoxical attitude that raised questions about the extent to which confidence had been restored. Most apparently expected sales to be very good next year; at the same time, they were disturbed about the atmosphere in which the wage board would be making its decisions. Their concern about the course of wages not only made them rather pessimistic with respect to the outlook for profits but also seemed to call into question their optimisim about sales. Finally, there was widespread worry that recessionary tendencies were building up in Europe which could endanger the prospects for the domestic economy.

Mr. Eastburn noted that the Philadelphia Bank staff had used the Board's model to run a simulation like that Mr. Partee had described, and had obtained similar results with respect to the growth rate in M_1 through the first half of 1972 that would be consistent with stable interest rates. However, when they extended the analysis through the second half of the year, they found a rising rate of monetary expansion. The expansion was sufficiently rapid to create upward pressures on wages and prices toward the year-end strong enough to nullify part of the favorable effect on expectations that the anti-inflation program had produced. Renewed inflationary expectations would, of course, contribute to the inflationary premium in interest rates and lead to upward pressures on rates. Thus, it appeared that an effort to hold interest rates constant would be self-defeating and would prevent the attainment of the goals for wages and prices.

Mr. Partee commented that the Board staff's simulation had been limited to the first half of 1972 because it was not at all clear that stable interest rates would be desirable for the full year.

It appeared likely that stable long-term rates would be needed in the first half if housing activity and State and local government outlays were to continue to expand as strongly as would seem to be necessary for the over-all recovery to proceed at a desirable pace. It was quite possible, however, that monetary policy would have to become more restrictive over the rest of the year and into 1973.

Mr. Eastburn agreed that there were risks in extending the simulation analysis beyond the first half. His point, however, was that the decisions the Committee reached now would have implications for events beyond mid-1972.

Chairman Burns asked whether he was correct in thinking that Mr. Partee was recommending a policy that would bring interest rates down in the near future in the hope that they would not turn up next year.

Mr. Partee responded that he was recommending a reduction in money market rates now with an eye to the consequences for longer-term rates. In his judgment, present money market conditions were too tight to achieve the kind of monetary expansion that was needed in order to keep longer-term interest rates from rising during the winter. Given the lags in the monetary process, he thought it was necessary to begin easing money market conditions now if long-term interest rates were to remain stable later.

The Chairman asked whether Mr. Partee was suggesting that long-term rates should be stable through the winter at about their current level or at some lower level.

Mr. Partee replied that he preferred to think in terms of a range rather than a particular level. Long-term market rates had already declined substantially since mid-August--nearly a full percentage point in the case of bond market yields--and a continuing abatement of inflationary expectations might lead to further declines, perhaps of another one-quarter point or so. The resulting level might be considered as the lower end of the band of rates which would be consistent with a desirable pace of economic expansion. If the economic recovery proceeded at about the pace the staff had projected, two opposing forces would be operating on interest rates in coming months; the recovery itself would tend to raise rates, while the abatement of inflationary expectations would tend to lower them. Unless steps were taken to increase the pace of monetary expansion, he suspected that the forces tending to raise interest rates would dominate, and that the higher rates would have harmful consequences for the economic expansion.

Mr. Morris said he doubted that economic growth would accelerate as rapidly as the staff projections indicated. In particular, the latest monthly statistics did not suggest to him that real GNP was growing at a 7 per cent annual rate in the current quarter. Also, he found it difficult to reconcile the recent sharp drop in the stock market with the projection that corporate profits were rising at a 25 per cent annual rate this quarter.

Mr. Maisel said it was his impression that the growth rate in real GNP of a little over 7 per cent that the staff was projecting for the current quarter and the first half of 1972 was about two percentage points higher than the consensus forecast. He asked whether Mr. Partee had the same impression, and if so, what factors accounted for the difference.

Mr. Partee responded that his views on the consensus forecast were based mainly on an examination of projections others had made for the full year 1972, rather than for the coming three quarters, so that it was difficult to compare the consensus with the staff's projection. He suspected, however, that the difference was more on the order of one percentage point rather than two. That difference might best be explained by saying that the staff thought it would be desirable for the Committee to see what growth rate would be produced by making optimistic assumptions about consumer confidence and hence about prospects for total spending.

Chairman Burns said he assumed it was also true that the staff thought the available evidence warranted an optimistic view.

Mr. Partee replied that the staff was not wholly of one mind on the matter. While he was more optimistic than some, he had to admit that an impressive body of evidence supporting that optimism was not yet at hand. In his view, objective evidence for the type of strong rise in consumer spending the projections called for was unlikely to develop until the rise was actually in process, since a strengthening of the magnitude in question had to be predicated on qualitative considerations--mainly the expected state of consumer confidence.

Mr. Mayo remarked that, while the staff projection appeared to be reasonable, he also thought it was a little on the optimistic side. For example, in light of current production schedules in the auto industry, the green book[1/] projection that sales of domestic models would be at an annual rate of 9.4 million in the fourth quarter seemed too high, even assuming some reduction in dealer stocks. Also, the projections for plant and equipment spending implied that the pick-up would begin in the first quarter of 1972, which was somewhat sooner than he would expect after observing the doldrums currently affecting the capital equipment industry in the Midwest.

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

A more important question--particularly from the point of view of Mr. Partee's recommendation for monetary policy--concerned the degree of fiscal stimulus expected, Mr. Mayo said. According to the green book, the full-employment deficit would be at an annual rate of about $6 billion in the first half of 1972. The staff's estimate of that deficit had been raised progressively over recent months and he suspected that it was still too low. For example, there still was a significant chance that the increase in social security taxes scheduled for January 1 would be postponed, and today's papers reported that the Administration was proposing a 1972 farm program that could increase food grain subsidies by $800 million.

Mr. Francis commented that the recovery from the recent economic slowdown appeared to be progressing at a satisfactory pace. Total spending on goods and services had risen substantially in the past year, and the latest available data indicated that the trend had continued. The probabilities were now high that the growth in total spending would accelerate in the near future, in view of both the rapid monetary injection during the spring and summer and the fiscal measures requested by the President.

As he saw it, Mr. Francis continued, the Committee's primary concern should be to assure that the expansion proceeded at a manageable pace, and that continued progress was made in reducing inflationary pressures. The freeze, as well as the Phase II programs, would probably appear to be successful in slowing the rise of measured prices and in stimulating employment for a period of time. However, a freeze or other control programs could not be expected to effectively restrain inflation unless accompanied by sound monetary actions. He shared Mr. Eastburn's concern about likely developments after the first half of 1972 if monetary expansion in the first half was at the 6 per cent rate suggested by Mr. Partee.

Mr. Kimbrel said he gathered from the green book and from Mr. Partee's statement that evidence was accumulating to support expectations of more rapid expansion in economic activity and some abatement of inflationary psychology. That also seemed to be the consensus of a group of Sixth District businessmen with whom he had met last week. They approved of the new economic program almost unanimously, although they did not expect immediate or spectacular results; and they believed that labor support and participation in the post-freeze stabilization program were necessary for its success. Attitudes about plant and equipment expenditures were mixed. For example, the textile industry had become more optimistic, and it was likely to embark on a program for substantial expansion if assured of a workable quota arrangement for imports.

Chairman Burns observed that the textile industry had been buying much of its equipment abroad, and Mr. Kimbrel agreed. Continuing, the latter reported that an executive from a conglomerate dealing in heavy equipment expected a major pick-up in sales and a doubling of the firm's capital expenditures from this year's level. On the other hand, an executive of a large national company indicated that his company would not increase capital spending significantly until demand for its products caught up with the present capacity.

Altogether, Mr. Kimbrel said, the discussion with businessmen had underscored in his mind the importance of maintaining public confidence in the ultimate success of the new economic program. It was especially important to reinforce the expectations of reduced inflation. In his judgment, the greatest contribution the System could make at this point would be to make clear that its policy continued to be one of restraining inflationary pressures.

Mr. MacLaury asked about the monetary policy assumptions underlying the staff projections of GNP. In that connection, he thought it would be helpful to the Committee if it could relate the GNP projections to one of the several alternative policy courses under consideration, and he suggested that as a regular practice the staff might specify the policy assumptions in the green book, along with the projections. He would also note that like some others he was concerned about the risk that the current projections were overly optimistic. Mr. Partee had indicated that the projected growth rate in real GNP depended to an important extent on an expectation that consumers would be sufficiently confident to step up their outlays substantially. He inquired about the specific kinds of evidence the Committee might keep in view in order to determine whether the actual performance of the economy was likely to be as strong as projected.

Mr. Partee replied that in its recent GNP projections the staff had been assuming a monetary policy that would result in broad stability for interest rates over the period covered. Rate stability was essential to the projections of residential construction activity and State and local government expenditures. He added that it was more than ordinarily difficult at present to make GNP projections because the new economic program had interrupted the continuity of developments and had altered many economic relationships. Conditions were beginning to settle down now, and he hoped that for the next meeting the staff would be able to present a chart show including new projections for all of 1972. In making those projections the staff would employ all of its methodological resources--econometric as well as judgmental--and would bring to bear all the latest evidence, including the strategically important data that would be coming in on retail sales. At that time better judgment should be possible as to whether the present projection for the first half was unduly optimistic.

Continuing, Mr. Partee said he agreed that the probabilities were greater that the pace of expansion through mid-1972 would fall short of the projected rate rather than the reverse. As he had indicated earlier, the staff had deliberately presented the most optimistic projection that appeared feasible--one that depended on a favorable evolution of economic relationships. Even that projection yielded an unsatisfactory result for the unemployment rate, which was expected to decline only to 5-1/2 per cent by the second quarter of 1972.

In reply to a question by Mr. Winn, Mr. Partee said the econometric model had suggested that profits would rise at an extraordinary pace over the projection period. The increase had been cut back somewhat in the judgmental forecast to take account of the effect of restrictions on price increases. Nevertheless, profits were still expected to rise substantially as output and expenditures expanded. An increase on the order of 20 per cent was indicated between the second quarters of 1971 and 1972.

Mr. Winn said he suspected that automobile production was being limited by bottlenecks, since some plants were operating on a 24-hour basis. He noted also that in the last few days three of the largest industrial firms in his District had reported sharp increases in new orders.

Mr. Coldwell said he would like to echo Mr. Francis' point about the need to focus on the appropriate monetary and fiscal policies to support the new economic program. With respect to capital expenditures, a number of businessmen in his District were becoming increasingly concerned about the magnitude of the expenditures that would be required in connection with pollution control. According to one estimate, the cost nationally might come to $30 billion over a few years. Since those expenditures would not yield any gains in productivity, they would contribute to upward pressure on prices. For gasoline the cost increase might come to 5 cents per gallon.

Mr. Coldwell then asked Mr. Partee for his view regarding the importance of international flows of funds and shifts in the size of Treasury deposits in accounting for the recent behavior of the money supply.

Mr. Partee replied that some part of the weakness of money in August may have reflected reductions in private demand deposits arising out of shifts of corporate balances abroad, with the funds returning in the form of Treasury deposits. However, according to the demand deposit ownership survey--which, incidentally, was proving to be very useful--households were primarily responsible for the weak performance of demand deposits in September. That could reflect a fundamental change in attitudes about precautionary balances.

Mr. Coldwell asked what assumptions had been made about the utilization of balances that consumers and others had been accumulating in estimating the growth rate of money needed to maintain stable interest rates in the first half of 1972.

Mr. Partee replied that the precautionary balances built up earlier in the year might be worked off by year-end, in light of the recent weakness of the money supply and the prospect that it would not rise much in the fourth quarter. Given the assumption that income velocity would drift up only gradually, the stock of money would have to grow relatively rapidly in the first half if dollar GNP was to expand at the projected annual rate of 10 per cent.

Mr. Swan noted that consumers might draw down their time and savings deposits. He asked what rate of growth in M_2 was expected to accompany the 8 per cent rate of expansion in M_1 in the first half of next year indicated by the simulation analysis.

In reply, Mr. Partee said no specific estimate had been made for M_2 in that analysis. However, if market interest rates remained relatively stable, as assumed, he would not expect the rate of increase in consumer-type time and savings deposits to change a great deal from the pace of recent months.

Mr. Axilrod expressed the view that M_2 would grow a shade more rapidly than M_1, perhaps at an 8-1/2 or 9 per cent rate. In any case, its growth was likely to be far slower than in the first quarter of 1971.

Mr. Maisel remarked that the relationship between GNP and money supply implicit in the staff's current projection was almost identical with that in the projections of last November and last February, and it differed substantially only from the relationship in the projection made in June. The relationship projected in the November and February presentations had proved to be correct.

Mr. Mitchell said he had some question about the relevance of such comparisons. In making policy, the Committee was not guided for an extended period by the relationships shown in staff projections; rather, it made policy from meeting to meeting, reappraising the situation each time in light of the new evidence that had become available, so that the monetary conditions underlying the earlier projections would in fact have changed with the passage of time.

Mr. Brimmer observed that the staff projections of M_1 over the past month had been reasonably good.

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 September 21 through October 13, 1971, and a supplemental report covering the period October 14 through 18, 1971. Copies of both reports have been placed in the files of the Committee.

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

> System open market operations during the past four weeks provided a substantial volume of reserves to the banking system, encouraging a gradual easing of money market conditions as measures of monetary growth fell short of paths envisaged at the last meeting of the Committee. At the same time, the Account Management refrained from undertaking aggressive moves to push in reserves under conditions that might have led market participants to conclude that a very substantial easing was intended. Under this approach, the Federal funds rate gradually worked down from the 5-1/2 per cent level prevailing around the time of the last meeting to around 5-1/4 per cent in most recent days. The objective in recent days has in fact been to foster a rate a shade under 5-1/4 per cent, but as was true through the past several weeks, the achievement has tended to lag the desire a bit as the Desk has avoided aggressive action that could mislead the market. Yesterday, the effective funds rate came down to 5-1/8 per cent.
>
> On the whole, markets in fixed-income securities were firm to strong over the interval, based largely on cautious optimism about the prospects for Phase II of the Administration's anti-inflation program. The somewhat easier money market atmosphere and the cumulative evidence of sluggish money supply growth were also constructive factors. Interest rates on a broad range of Treasury coupon issues declined by roughly 1/8 to 3/8 of a percentage point. Last Friday, the Treasury successfully sold at auction

$2 billion of a 40-month 5-7/8 per cent note, at an average yield of 5.58 per cent. This yield was roughly 1/4 to 3/8 of a percentage point under the rate that might have had to be paid a month earlier, and it was close to a full percentage point under the rate that might have been needed two months earlier--just before the President's mid-August speech.

Indicative of the caution with which market optimism has been tempered, there has been little net change in dealer positions in coupon issues due in over a year. In fact, through last Friday, the dealers' holdings of such issues were down roughly $100 million since the time of the last Committee meeting, but purchases in the auction on Friday would convert that decline to an increase--also of roughly $100 million.

Treasury bill rates, which had shown little net change in the four weeks preceding the last Committee meeting, have moved down approximately 1/4 to 1/2 of a percentage point, reflecting moderate continuing foreign purchases, some System buying, and the somewhat easier money market and financing costs. In yesterday's auction, average rates of 4.49 and 4.64 per cent were set for the three- and six-month bills, compared with 4.74 and 4.99 per cent four weeks earlier. There remains in the background of the bill market a concern over what may happen when foreign money outflows reverse, but this is generally regarded as some months away.

In the corporate market there has been a fairly steady decline in yields over the past several weeks, bringing yields on new high-grade utility offerings back to around the 7-1/2 per cent level. Investors had resisted this rate level when the market approached it shortly after the mid-August speech, and you may recall that at the time of the last Committee meeting high-grade utility issues had backed up to around 8 per cent and were not far below the early August levels. The recent improvement, as in the Government market, seems to reflect tempered optimism about Phase II, as well as the fact that the calendar of scheduled issues has not built up as seemed to be threatening a month ago. The market's optimism is guarded here, too, however, and it appears that rates around 7-1/2 per cent, while acceptable, do not generate great investor enthusiasm.

Yields on tax-exempt issues have also moved down over the interval by roughly 30 to 40 basis points.

Much of that decline was spurred by fairly active bank buying interest.

In supplying reserves over the past interval, the System Account bought $177.5 million of Treasury coupon issues. It also purchased $95.9 million of various Federal agency securities, marking the first operations under the Committee's new authorization. The agency issues were bought in two go-arounds of the market, a week apart in time, the first concentrating on maturities through 1973 and the second taking in longer maturities. In these operations, we were offered a good selection of issues and were able to buy moderate amounts close to quoted market prices, and without stirring up much price movement subsequent to our entry. As anticipated, the operation is more cumbersome than a Treasury coupon purchase operation, but we hope to gain additional facility as time goes on.

The Treasury securities market is currently awaiting the terms of the November refunding operation which should be announced on October 27. There is widespread anticipation that the Treasury may again venture out in the longer-term area, making further use of the limited authority to sell bonds with a yield above 4-1/4 per cent. A number of market participants seem to be thinking of an issue in the 10-15 year area, as part of a two- or three-pronged offering. There is also widespread discussion of the possibility that the Treasury may take this occasion to pre-refund issues due in 1972 or later, in order to take advantage of a good market atmosphere and make a little headway on debt restructuring. Apparently in anticipation of an attractive offering, the dealers have built up their holdings of coupon issues due within a year to over $800 million as of last Friday--up from $350 million four weeks ago.

The System holds $3,574 million of the issues maturing November 15, and we would plan to exchange these in the refunding, choosing among the options the Treasury offers approximately in proportion to anticipated public takings.

As mentioned in the press yesterday, the General Accounting Office has just issued a report on the Government securities dealers' financial statements that is quite critical of the accounting practices employed in those statements. The statements, as you know, are regularly submitted to the Federal Reserve. A committee with representation from the Board staff, the New York Reserve Bank, and the Treasury, which has responsibility for overseeing the dealers' statistical and financial reporting program, will be meeting shortly to consider the GAO report and recommendations, and to determine what sort of follow-up action should be recommended. As to the substance of the criticism I would say at this point that while the financial data are certainly far from perfect, and should be improved, they are of value in following broad trends in the financial health of the Government securities market.

One final matter: In the week of September 20-24 the Desk was visited by two officers from the San Francisco Federal Reserve for training in the reconstruction of the System Account and conduct of open market operations in the event of a national emergency that put New York out of operation. While this particular visit was at the initiative of San Francisco, we now propose a System-wide training program of this nature, for each of the Banks and the Board staff, similar to the emergency training program undertaken about 8 or 9 years ago. We have in mind taking on, two at a time for a one-week period, one to three persons from each Reserve Bank and the Board staff. Accordingly, we invite each of the Reserve Banks to be in touch with the Account Management if they have some names and dates to suggest.

Chairman Burns referred to Mr. Sternlight's comment about the plan for Federal Reserve and Treasury staff members to meet shortly to consider the GAO report. The Chairman said he hoped the staff group would act promptly in formulating its reactions and recommendations, and that its own report would be complete and constructive.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 21 through October 18, 1971, were approved, ratified, and confirmed.

Mr. Axilrod made the following statement regarding monetary relationships discussed in the blue book:

Although there are still major uncertainties as to international exchange and domestic incomes policy developments, the situation has been clarified enough over the past several weeks, I believe, to make it more feasible for the Committee now to give greater weight to the longer-run effects on monetary aggregates and credit conditions of current operating strategy. We still cannot be certain, of course, about the exact impact of the wage-price program and international negotiations on the demand for money and on the level of interest rates. But some directions of effect seem clear. To the extent that the wage-price program is successful in reducing inflationary expectations it should work to lower interest rates. And to the extent that it, together with a less uncertain international situation, engenders confidence, precautionary demands for cash and liquidity should be reduced. On the other hand, large-scale reflows of funds from abroad, when they occur, could lead to sizable transitory increases in domestic cash holdings and distortions in the interest rate structure.

The longer-run calming effects that might be expected from the new economic program seem to have been at work during the past few weeks. We have experienced a definite slowing in growth rates of both M_1 and M_2 in August and September, with growth of M_1 turning negative last month. In addition to the usual lagged reactions to earlier high market interest rates and the effect on M_1 in August of outflows of funds abroad, the slower growth probably also reflects an enhanced degree of public confidence that has caused deposit holders to utilize some of their balances for spending and to accelerate investment in interest-earning assets. This slower growth in money has helped to average out the unusually rapid growth rates of spring and early summer and has in itself, together with the wage-price program, had a favorable effect on credit market expectations and interest rates.

Both short- and long-term interest rates are well below their mid-August levels, with long-term rates down from 3/4 to 1 percentage point. Short-term rates are off from 3/8 to 3/4 of a percentage point, but most recently, as day-to-day money market conditions have continued slowly but steadily to ease, there have been increasing signs of give in the private short-term rate structure.

A more rapid expansion in the money supply aggregates than over the past two months is likely to be required, as Mr. Partee has stated, if the projected expansion in GNP is to be financed without excessive interest rate pressures, if any. All three alternatives before the Committee contemplate such a greater expansion in money.1/ But, taking alternatives A and B as the practical alternatives for consideration, the rate of expansion in M_1 is expected to remain a modest 2-1/2 or 3 per cent on balance over the fourth quarter, while building to 4-1/2 and 6 per cent, respectively, in the first quarter of next year as the lagged effect of recent and/or near-term prospective easing of money market conditions takes hold.

The directive corresponding to alternative A has the primary instruction framed in money market terms, which may have a certain amount of appeal because of the even-keel period coming up. But that would not appear to be consistent either with an effort to ease the constraints on policy imposed by even keel or, more importantly, to indicate that recent low growth rates in money supply aggregates are not representative of the Committee's longer-run objectives. Thus, it seems reasonable to continue the primary focus on aggregates of the previous directive, while also giving it a longer-run focus, as noted in the language of alternative B.

There is no necessary reason, of course, to confine the specifications associated with a directive phrased as alternative B to those noted for it in the blue book. The Committee may not wish to move the funds rate to a level as low as 4-1/2 per cent between now and the next meeting. On the other hand, at the previous meeting the Committee did indicate its willingness to countenance a funds rate as low as 4-3/4 per

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

cent. In view of the lagged effects between money market conditions and the monetary aggregates, it would seem desirable now to begin moving the funds rate down to 5 per cent and perhaps a little below if the Committee wishes to continue on a longer-run moderate growth path for the aggregates.

With an even-keel period in prospect--the Treasury, as Mr. Sternlight mentioned, will announce the terms of its November refunding a week from tomorrow--it might be desirable as a matter of strategy to move the funds rate to 5 per cent or a little below rather promptly after the Committee meeting. That would in practice represent a continuation of the easing trend of the past few weeks. From around that level, the rate could be permitted to flex upwards if the aggregates appeared to be a lot stronger than now expected, or could be permitted to flex downwards if the aggregates were substantially below path--if, for instance, M_1 growth again turns negative.

Chairman Burns observed that the Committee was ready to start its discussion of monetary policy. He would depart from his usual procedure and state his views briefly at this point--not because his thinking was very firm or because he wanted to influence the thinking of any one else, but because he would like to have the Committee focus on a subject that concerned him deeply. That subject was the behavior of interest rates over the months ahead. In his judgment it should be possible to get through the coming year with a minimum of difficulty if interest rates remained close to their present levels, and he would anticipate no particular problems if there were some further declines of a gentle and modest sort. However, if the System were to take active steps to bring rates down substantially over the next few weeks or months, it could produce conditions that would require rising rates next year, and that could result in serious difficulties. That possibility worried him a great deal, and he hoped the Committee members would comment on the subject in the course of the discussion.

As to the money supply, the Chairman continued, he thought the rate of growth of M_1 through the month of July had been so extraordinarily rapid that the Committee need not be concerned if the more recent weakness continued for another month or so. If he had any concern about economic consequences of such moderation, he would be advocating actions to stimulate monetary expansion despite the probable consequences for interest rates.

The Chairman then called for the go-around of comments on monetary policy and the directive, beginning with Mr. Hayes, who made the following statement:

> Over the years we have often stressed the need for monetary policy to tread carefully along a very narrow path if it was to contribute effectively to sound economic development. In the present setting this need is more than ever apparent. A strong but not excessively fast recovery is required to enable the Phase II program to work. Too rapid a rate of growth--say a rate much above that projected by the Board staff--would run the risk of reigniting demand-pull inflationary pressures, while a slower rate would fail to generate the needed improvement in employment. Either of these developments would seriously erode public support of the Phase II program.

In trying to set an appropriate goal for growth of the money and credit aggregates, I think we must keep in mind the highly stimulative character of current fiscal policy. This suggests to me that we should be well satisfied with something like a 5 to 6 per cent rate of growth in M_1 over a fairly extended period--and perhaps an 8 to 9 per cent growth rate in the credit proxy. Against this background, the sharp drop in money expansion of the past two or three months after the grossly excessive rate of earlier months has been, I think, all to the good; and I would not be concerned with continuance of subnormal growth for a month or two longer. The evidence points to very wide recent swings in the demand for cash balances, which we cannot hope to measure accurately, nor can we hope to compensate for them with any degree of accuracy.

This is another way of saying that I would advocate a no-change policy at this time on purely economic grounds, even if we were not faced within a week or so with a Treasury refunding which calls for an even keel. If short-term rates tend naturally to drift a bit lower--and they may be influenced by the declining tendency of foreign interest rates--we should let it happen, but we should certainly not try to push rates down. I would think in terms of a Federal funds rate in a range of 5 to 5-1/2 per cent, with a preference for the lower half of the range if the aggregates behave as they have been doing recently. Member bank borrowings might range from \$200 million to \$400 million, and net borrowed reserves from zero to \$200 million. As for the directive, I prefer alternative A, although I would be equally satisfied to use the language of alternative B with the money market specifications of alternative A.

I believe it would be a serious mistake to alter the discount rate in the period before our next meeting in mid-November. The rate is not out of line with market rates generally, and a lowering of the discount rate could signal to the public an abandonment of any intention to back up the Administration's anti-inflationary program with monetary policy.

Mr. Hayes noted that he had planned to express a sense of concern about the outlook for interest rates in his statement today. However, he had been greatly heartened by the Chairman's comments on that subject. Since his own thinking was very close to the Chairman's, he had nothing to add.

Mr. Francis commented that reported figures showed the growth rate in the money supply had slowed in the last couple of months. However, because of shortness of the period, problems of seasonal adjustment, and the unusual build-up of Treasury deposits, the Committee could not be certain that that recent slower money growth marked the beginning of a lasting trend growth rate lower than that experienced since late 1966. The growth of Federal Reserve credit and of the monetary base had not slowed as much as money in recent months. That indicated that other factors were accounting for the slowdown of money, and the influence of those factors might reverse in coming months and contribute to a rapid reacceleration of money growth.

Mr. Francis said the Federal Reserve could make a major contribution toward achieving price stability by reducing the trend growth rate of money below the 6 per cent rate which had prevailed since late 1966. He favored the money growth path implied by alternative A which, according to staff projections, would average a 3-1/2 per cent rate to March 1972. According to the St. Louis Bank studies, that rate, if further continued, would be consistent with the achievement of price stability. He did not favor the more rapid rate implied by alternative C because it represented a continuation of the trend growth rate of money which had prevailed over the last five years.

With regard to the language of the directive, Mr. Francis said he favored that of alternative B which gave instructions in terms of monetary aggregates rather than money market conditions. He also favored focusing the Committee's attention on a longer time horizon; therefore, he thought it appropriate that the directive specifically refer to desired monetary expansion "over the months ahead." He preferred that the Manager place a loose interpretation on the reference to the forthcoming Treasury financing so as to avoid straying away from a path of moderate monetary expansion.

With regard to the outlook for interest rates for the balance of this year and into 1972, Mr. Francis noted that the St. Louis Bank's analysis indicated that strong opposing forces would be influencing market interest rates. On the one hand, there should be downward movement of interest rates to the extent market participants revised their expectations of the average rate of inflation over the relevant future. Thus, as confidence gradually grew that the new economic program, coupled with a moderated monetary stimulus, was effectively reducing the trend rate of price increases, the inflationary premium built into today's market interest rates should decline.

However, Mr. Francis continued, opposing forces would be simultaneously pushing up on interest rates. The Government deficit was expected to be very large, which meant the markets would have to absorb large quantities of Treasury securities. Business demands for capital had always risen during the expansionary phase of the business cycle, causing interest rates to move procyclically, and that pattern would be strengthened in the present recovery by the new economic program. Also, household expenditures were being stimulated, and he would expect demands for consumer credit to rise and thus add to the real upward pressure on interest rates.

Mr. Francis indicated that he was uncertain as to the net effect on interest rates of those opposing forces. It seemed that inflationary expectations would be revised downward only very slowly as hard evidence developed that the war on inflation was being successfully waged. Thus, he would not be surprised to see the familiar procyclical movement of interest rates dominate the near-term future. In view of that possibility, he suggested that rates of interest be allowed to find their own levels in the market and, if strong market demands for credit should cause upward pressure on interest rates, that such a tendency not be resisted by System action or by any other means.

Mr. Kimbrel said he was pleased that market forces appeared to be urging interest rates slightly lower and he would not necessarily want to resist actively any further declines that might occur. However, he would prefer to see interest rates remain relatively stable over the near-term. In addition to the considerations the Chairman had mentioned, rate stability might also contribute to a further cooling of inflationary expectations. Accordingly, he favored the specifications associated with directive alternative A. He had no strong preference with respect to language, and could accept that of either A or B.

Mr. Eastburn commented that he had been happy to hear what the Chairman had said about interest rates. Those remarks had set forth effectively one of his own beliefs--namely, that if the Committee attempted actively to press interest rates down in the short run it would create problems later on. He would be particularly concerned about any attempt to achieve lower interest rates in the brief period before the Treasury financing. Looking to the longer run, he thought an effort to keep interest rates from rising probably would result in substantial rates of growth in the monetary aggregates, and that in turn would increase the difficulty of holding the line on wages and prices--and also on interest rates--particularly in the second half of 1972.

Mr. Eastburn noted that those considerations had led him to eliminate the specifications of alternative C as a possibility. At the same time, he thought the aggregate growth rates specified under alternative A probably were lower than those that would be associated with the desired pace of economic growth. The ideal situation would involve the interest rate levels of A and the aggregate growth rates of B, but if a choice had to be made he would give priority to the objective for interest rates. For directive language he favored that of alternative B.

Mr. Winn said he shared Mr. Eastburn's view that the maintenance of interest rates around their current levels at this time would give the Committee more flexibility in its policy next year. Hopefully, the aggregates would be found to be growing at appropriate rates as the turn of the year approached. He favored the specifications of alternative A and the language of alternative B.

Mr. Sherrill observed that he favored both the specifications and the language of alternative A. He did not share the staff's optimistic view of the economic outlook; on the whole, the evidence suggested to him that the recovery would be more gradual than their projections indicated. Nevertheless, he thought the interest rate specifications of alternative A--which, he noted, allowed for the possibility of some slight further declines in the period ahead--were appropriate to the current economic situation. As to the money supply, he agreed that the recent weakness could be permitted to continue for a while longer, in view of the very rapid growth earlier in the year. If the weakness should be protracted, however, it would become necessary for the Committee to act.

Mr. Brimmer said he preferred the specifications of alternative A not only because he agreed that it would be inappropriate for the Committee to try to drive interest rates down in the short run but for another reason as well. The new economic program represented a fundamental change in the approach to economic stabilization of a kind that many Federal Reserve people had been urging for some time. That change had implications for monetary policy which should be carefully considered by the Committee. The objectives of policy included not only the attainment of desirable rates of economic growth but also the abatement of upward pressures on prices, and the growth rates in the aggregates best suited to those objectives might well be different now from what they were before the President's mid-August address. For that reason he thought it would be desirable for the Committee to focus on the short run today, in the expectation that it would be in a better position at its mid-November meeting to determine the appropriate policy for the longer run.

Chairman Burns noted that he concurred in Mr. Brimmer's comments. Indeed, he might have made a similar point had he spoken at greater length in his remarks at the beginning of the go-around.

Mr. Maisel said he agreed that the Committee should be concerned with the question of what monetary policy would best complement the new economic program. He thought, however, that the critical issue was not interest rates but rather the supply of reserves. As Mr. Francis had suggested, interest rates were influenced by demands for money arising out of the course of economic activity as well as by the supply.

Mr. Maisel noted that if the money supply expanded in the fourth quarter at about the 3 per cent rate projected under alternative B, growth over the 1970-1971 period would average 6 per cent per year. Given the weakness in economic activity in the period, that growth rate had been appropriate. The question now was what growth would be required in the first half of 1972. In his judgment, an 8 per cent rate--as suggested by the simulation with the staff's model--would be too high, but the rate should not be less than 6 per cent.

It was unfortunate, Mr. Maisel continued, that the Committee was not operating with a reserves target, for it would then be asking the right question--namely, what rate of increase in reserves was required to achieve a 6 per cent growth rate in money in the first half of next year. Since the August meeting, when the Committee had debated the issue of operating targets, reserves had deviated significantly from the desired path only in the last two weeks--particularly in the last week, when they had fallen well below path. If the Committee were now to focus closely on the objective of maintaining current levels of interest rates, it was likely to provide an inadequate volume of reserves and consequently to induce increases in interest rates later on. Accepting the staff projection of economic activity as a proper goal, he believed that the rate of growth in reserves would have to be increased in the period immediately ahead. He favored the specifications and the language of alternative B. That would mean moving the Federal funds rate down to 5 per cent before the Treasury's refunding announcement, in accordance with the staff's view that the demand for reserves would otherwise be too low to get the desired expansion. The target for the funds rate after the even-keel period would be determined in light of the actual movements of the aggregates in the interim.

Chairman Burns noted that Mr. Maisel was commenting on the appropriate growth rate of M_1 in the first half of 1972, whereas the policy alternatives in the blue book specified growth rates only through the first quarter. If the Committee followed a course that resulted in less than 6 per cent growth in the first quarter, it could still achieve a 6 per cent rate for the first half if it so desired.

Mr. Maisel agreed. However, he thought it was important that the Committee begin to move toward the appropriate growth rate soon so that it could accomplish the change gradually; the longer it delayed the greater the risk that it would have to whipsaw the money market to achieve its objectives for the aggregates. In particular, it seemed clear that the Committee should not again put itself in a position in which it had to move as rapidly as it had last spring.

Mr. Mitchell said it seemed clear to him that the central issue facing the Committee today concerned its policy with respect to interest rates, and he thought that fact should be recognized in the language of the directive. He considered the money market specifications of alternative B to be essentially correct, although he would be willing to shade them a bit toward those of A. However, he did not like the language of alternative B, since by focusing on the aggregates it failed to indicate any implications for interest rates. He would prefer a second paragraph along the following lines: "To implement this policy, the Committee seeks to achieve over the months ahead an environment in which longer-term interest rate levels, while adjusting to market conditions, will reflect stability programs and objectives, and there will be no more than a moderate growth in monetary and credit aggregates." To his mind that language expressed an intent that was both proper and reasonably likely to prove attainable.

Messrs. Maisel and Brimmer expressed the view that language of the type Mr. Mitchell had suggested would be more appropriate in the statement of the Committee's general policy stance at the end of the first paragraph of the directive than in the second paragraph.

Chairman Burns remarked that it might be better to say that the Committee sought to "promote" rather than to "achieve" the stated objectives. Use of the word "achieve" might imply that the Committee had more power to determine interest rate levels than it in fact had.

Mr. Mitchell said he would have no objection to such a modification. Nevertheless, he thought that from the public's standpoint the Committee had an obligation to take a position with respect to interest rate policy for the next two or three months. He did not disagree with the Chairman's earlier observations about interest rates. However, like Mr. Maisel he believed that moderate growth in the aggregates would be desirable to reduce the risk of a subsequent increase in interest rates.

Mr. Black remarked that he was concerned about the unexpectedly sharp deceleration of the aggregates in recent weeks. However, he thought the Committee should await further developments before attempting to change the situation. Accordingly, he favored the adoption of alternative A today.

Mr. Clay commented that developments in the money and capital markets in recent weeks generally had been very constructive.

Several factors had contributed to that situation. Monetary policy had been one important factor, with its approach that was receptive to lower interest rates without aggressively promoting that result.

Mr. Clay noted that credit markets apparently were very sensitive to indications on the price inflation front. That presumably would continue to be the case in the weeks ahead, including reflections of wage and price prospects and actions under the Phase II program.

In the forthcoming period, Mr. Clay said, monetary policy should continue to be accommodative to further downward movement in interest rates. As such, it also should continue to avoid evidence of aggressive Federal Reserve efforts to bring interest rates down because of the likely adverse impact on both credit markets and inflation psychology. It was essential that the monetary aggregates show some growth in the months ahead, but in view of the large growth earlier in the year and current liquidity, that growth could be quite modest for a while. All of that seemed to suggest monetary policy specifications falling somewhere between those associated with alternatives A and B. His main concern about the B specifications was that the implementation of those money market conditions might lead to public interpretation that the Federal Reserve had shifted to an aggressive interest rate policy.

It seemed to Mr. Clay that the business and financial community and the public generally were cautiously optimistic at present. However, if there were a sharp reduction in interest rates or a sharp increase in the money supply at this time, that cautious optimism could be converted into an inflationary optimism. He believed the Committee should continue to move along lines like those it had been following recently to avoid creating such a shift in attitudes.

Mr. Mayo said he would like to compliment the Desk on what he thought had been an adroit implementation of the policy course the Committee had decided upon at the previous meeting. In his judgment that policy--which, in effect, called for taking judicious advantage of opportunities to follow the market down toward slightly lower levels for the Federal funds rate against the background of slower growth of aggregates--had worked very well and should be continued. He thought the specifications of alternative A would be consistent with that approach, except that the range indicated for the Federal funds rate--5 to 5-3/8 per cent--seemed to him to be too narrow. He would have no objection to a funds rate as low as 4-3/4 per cent if it could be achieved with the same adroitness as had been employed in the recent period.

Mr. Mayo observed that he favored the language of alternative A also. For nearly a year he had been waiting patiently for conditions to develop under which it would be appropriate to formulate the primary instruction of the directive in terms of money market variables and to deal with the aggregates in a proviso clause. In his opinion those conditions were now at hand.

Mr. MacLaury remarked that he concurred fully with the Chairman's views regarding the importance of interest rate developments in the months ahead. At the same time, as he had indicated earlier he thought the risks were that the staff's GNP projections were overly optimistic. For that reason he would hope to avoid a situation in which long-term interest rates would be under upward pressure in the early part of 1972.

On balance, Mr. MacLaury said, he would favor the language of alternative B with specifications halfway between those associated with A and B. He would not want to have the Desk work actively to reduce the Federal funds rate, and certainly not in the brief period before the Treasury financing announcement. However, like Mr. Mayo he believed it would be desirable to continue to follow the market down at a gradual pace, assuming the market was tending in that direction.

Mr. Swan said he agreed in general with Mr. MacLaury. He preferred the language of alternative B, which was similar to that of the previous directive, since he thought the course the Committee had been following recently should be continued. He favored a range for the Federal funds rate from about 4-3/4 per cent to about 5-1/4 or 5-3/8 per cent. While he agreed that the Desk should not be instructed to push rates down actively, he thought the Committee should be prepared to accept a reasonable degree of fluctuation and that it should not be unwilling to have the funds rate follow the market down within limits.

In that connection, Mr. Swan continued, he had been struck by the statement in the blue book that "over-all credit conditions--as typified by behavior of short- and long-term interest rates--might well ease between now and the next meeting even under alternative A." He expected that the System would have to give serious consideration to a possible change in the discount rate, particularly if the Federal funds rate were to move below 5 per cent. The question might well have been an immediate one were it not for the forthcoming Treasury financing and the considerations the Chairman had mentioned at the beginning of the go-around.

Mr. Coldwell noted that he approached the policy question today with serious doubts that the growth trend of M_1 had weakened as much as the recent figures suggested. He suspected that the weakness in the figures did not reflect fundamental forces, but rather was due mainly to such extraneous factors as international flows of funds and shifts in Government deposits. For that reason, he would be inclined to place more emphasis on the reserve aggregates, which had shown considerable strength in recent months. More importantly, there already was a good deal of liquidity available to meet foreseeable demands at current rates, especially in view of the possibility of transfers from time to demand deposits. He agreed that the Committee should not attempt to push interest rates down at the present time and certainly that it should not try to do so quickly.

Looking ahead, Mr. Coldwell said he hoped the Committee would avoid a repetition of its earlier mistake of over-compensating for a prior quarter's shortfall in the money supply, and that it would make no advance commitment to enlarge reserve injections or money supply growth substantially in the first quarter of 1972. He was especially concerned about the low visibility of first-quarter conditions, in the absence of knowledge of the degree of effectiveness of the Phase II program--or, indeed, of the degree of compliance with that program--and in the absence of information on the outcome of the current international problems.

Putting such considerations together, Mr. Coldwell said, he favored the specifications of alternative A except that he would modify them to permit the Desk to follow minor market-originated downdrifts in money market conditions. In particular, he favored growth in reserves at about a 5 per cent rate and a range for the Federal funds rate of 4-7/8 to 5-3/8 per cent, but with a strong preference for funds rates above 5 per cent. He also preferred the language of alternative A, partly because of the Treasury financing and the other factors making it desirable to focus on interest rates at this time, but also because the data on the monetary aggregates were apt to be misleading under present circumstances.

With respect to the first paragraph of the directive, Mr. Coldwell observed that he had some question about the statement in the draft reading "The 90-day freeze has effectively limited increases in prices and wages." It might be desirable to add the phrase "for the time being," since no one could say at this point whether the freeze would remain effective. As to the discount rate, he would be opposed to any reduction in the near future.

Chairman Burns remarked that the problem in the first paragraph that Mr. Coldwell had noted might be dealt with by inserting the words "thus far" before "effectively," so that the statement would read "The 90-day freeze has thus far effectively limited increases in prices and wages."

There was general agreement with that suggestion.

Mr. Morris said he favored alternative B. He was very much in sympathy with the point the Chairman had made at the beginning of the go-around; the Committee had to be wary of any policy prescription that would induce declines in short-term interest rates so large as to require a reversal later. On the other hand, he was not convinced that interest rates had already declined to levels that would prove acceptable for an extended period. No doubt his view was conditioned by his belief that the staff's GNP projections were overly optimistic.

It seemed to him, Mr. Morris continued, that for reasons already stated by Messrs. Maisel, MacLaury, and Swan, the Committee should give the Manager the leeway necessary to ease the funds rate down somewhat. He was concerned that adoption of the specifications of alternative A would lock policy into a stance that would be too restrictive if maintained for more than a short period. A compromise range for the funds rate of 4-3/4 to 5-1/4 per cent would be acceptable to him.

Mr. Robertson made the following statement:

> In the current economic situation I think the best kind of monetary policy to adopt is one that might be called prudent.
>
> Our economic recovery seems to be strengthening. It needs the support of a generally accommodative monetary policy, but not a policy so easy that it fuels a pick-up in inflationary pressures.
>
> The recent movements of most monetary aggregates have been slack enough to offset a good part of their spring bulge. It seems wise to move to prevent that slackness from going too far, but to do so cautiously enough so as not to risk starting another bulge of monetary expansion.
>
> Market interest rates have moved lower since the announcement of the President's new economic program, and it is desirable that they continue to work gradually lower, but we should try to avoid setting off a speculative downward rate push in the markets that could create false illusions of excessive ease and sow the seeds for a troublesome backlash of rates later.
>
> Taking all these considerations into account, I believe a prudent policy course would be to tell the Manager to continue to provide gradually greater reserve availability. This policy could be achieved under the language of draft directive B, but I would like to add one caveat to that. I do not think the Manager should act abruptly to move the Federal funds rate down into the 4-1/2-5 per cent range suggested by alternative B in the blue book. I think he should move slowly on this, and wait a few days in order to avoid playing into the hands of those market professionals who watch the money market closely on the days

> immediately following the Open Market Committee meeting for clues as to our policy intent.
>
> With this qualification, I am prepared to vote for alternative B.

Mr. Robertson added that he would not favor focusing primarily on money market conditions. In particular, he would not want to instruct the Manager to work actively to reduce the Federal funds rate, or to try to hold it up if--as he expected--it was tending to decline of its own volition. As he had indicated, the emphasis should be on moving gradually and in a minor way toward providing greater reserve availability. He agreed that the Committee should be alert to the possibility that the policy actions it took now might create problems later. However, he would note in that connection that any interest rate increases that might occur later were likely to create fewer problems if they started from a lower level.

Chairman Burns observed that, while most members had expressed a preference for one of the staff's alternative directives, Mr. Mitchell had proposed different language. He asked whether any members other than Mr. Mitchell preferred the language the latter had suggested.

No members responded affirmatively.

The Chairman then said it appeared from the go-around that the Committee might be prepared to adopt the language of alternative B and specify a 4-3/4 to 5-3/8 per cent range for the Federal funds rate. He asked whether any members would be opposed to that course.

Mr. Brimmer observed that alternative B referred to growth in the aggregates "over the months ahead." He asked whether the Chairman contemplated having the suggested specifications for the Federal funds rate apply only to the period before the next meeting of the Committee.

Chairman Burns responded affirmatively.

Mr. Clay noted that the range proposed for the funds rate overlapped those shown in the blue book for alternatives A and B. He asked whether it would not be desirable to specify a range for member bank borrowings that involved a similar overlap.

In response to a question, Mr. Sternlight said he would expect borrowings to be quite light if the Federal funds rate were to work down toward the 5 per cent discount rate and perhaps drift lower.

Mr. Robertson remarked that he would not put much emphasis on the borrowing figures at the moment because they were likely to be heavily influenced by special factors affecting one member bank.

Mr. Mitchell commented that the Manager could make special allowance for any borrowings by that bank in interpreting the figures.

After further discussion, the Committee agreed that the range for member bank borrowings should be widened commensurately with the widening of the range for the funds rate.

Mr. Eastburn asked what growth rates for the aggregates would be contemplated under those money market specifications. He assumed they would fall somewhere between those shown in the blue book under alternatives A and B.

Mr. Axilrod observed that the proposed range for the funds rate was the same as that associated with alternative A except that the lower end was reduced by one-quarter of a percentage point. Accordingly, he would expect the aggregates to grow at roughly the alternative A rates in the fourth quarter, although their growth might be affected later on if the funds rate moved below 5 per cent during the coming period. The Committee could, of course, specify a desired path for the aggregates other than that shown under alternative A.

Mr. Maisel said he doubted that the Committee would favor a growth path for M_1 below that shown under alternative B, which involved expansion at an average rate of only 2-1/2 per cent in October and November. He thought the Manager should be instructed to move toward easier money market conditions after even-keel considerations were no longer important if M_1 was falling short of the B path.

Chairman Burns said he had assumed that, if the Committee approved the range for the funds rate he had suggested earlier, it would be anticipating growth in the aggregates along the path specified under alternative A. He asked whether the members would prefer the B path.

Messrs. Maisel, Mitchell, Morris, and Robertson responded affirmatively.

Mr. Mitchell then suggested that the Committee consider a growth path intermediate to those shown under alternatives A and B.

The Chairman expressed the view that such a course would be cutting the matter too finely, since the difference between the two paths in the fourth quarter was not great. He then proposed that the Committee vote on a directive consisting of the staff's draft of the first paragraph, with the modification in the statement concerning the 90-day freeze that had been agreed upon earlier, and alternative B for the second paragraph. It would be understood that the range contemplated for the Federal funds rate would be widened from that associated with alternative A to 4-3/4 to 5-3/8 per cent, and that the range for member bank borrowings would be widened commensurately.

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

> The information reviewed at this meeting indicates that real output of goods and services expanded modestly in the third quarter and that unemployment remained substantial. However, there are indications of a strengthening in economic activity since the mid-August announcement

of the Government's new economic program. The 90-day freeze has thus far effectively limited increases in prices and wages, and the general framework of the post-freeze stabilization program has been established. The narrowly defined money stock, which had grown rapidly through July, increased much less in August and declined in September. The broadly defined money stock increased slightly in September as inflows of consumer-type time and savings deposits to banks continued at the moderate August rate. However, the volume of large-denomination CD's outstanding rose sharply, and the rate of expansion in the bank credit proxy remained relatively rapid. Market interest rates have declined in recent weeks and are appreciably below their mid-August levels. The U.S. foreign trade balance remained in heavy deficit in August. Outflows of short-term capital, which had been massive in August, were much smaller in September. In recent weeks the market exchange rates for some foreign currencies against the dollar rose further, while foreign official reserve holdings increased substantially. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to achieve moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective, taking account of the forthcoming Treasury financing.

Chairman Burns then noted that a memorandum from the Secretariat dated October 13, 1971,[1/] set forth a tentative Committee meeting schedule for 1972 which called for twelve meetings at monthly intervals. He asked whether there were any questions about the proposed schedule.

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

There was some discussion of the possibility of shifting one of the proposed meeting dates forward by a week. At the conclusion of the discussion the Chairman remarked that on balance it might be best to employ the tentative schedule originally proposed, and no objections were raised.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, November 16, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

Attachment A

October 18, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 19, 1971

FIRST PARAGRAPH

The information reviewed at this meeting indicates that real output of goods and services expanded modestly in the third quarter and that unemployment remained substantial. However, there are indications of a strengthening in economic activity since the mid-August announcement of the Government's new economic program. The 90-day freeze has effectively limited increases in prices and wages, and the general framework of the post-freeze stabilization program has been established. The narrowly defined money stock, which had grown rapidly through July, increased much less in August and declined in September. The broadly defined money stock increased slightly in September as inflows of consumer-type time and savings deposits to banks continued at the moderate August rate. However, the volume of large-denomination CD's outstanding rose sharply, and the rate of expansion in the bank credit proxy remained relatively rapid. Market interest rates have declined in recent weeks and are appreciably below their mid-August levels. The U.S. foreign trade balance remained in heavy deficit in August. Outflows of short-term capital, which had been massive in August, were much smaller in September. In recent weeks the market exchange rates for some foreign currencies against the dollar rose further, while foreign official reserve holdings increased substantially. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, 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; provided that somewhat easier conditions shall be sought, taking account of the forthcoming Treasury financing, if it appears that the monetary and credit aggregates are falling significantly below the growth paths expected.

Alternative B

To implement this policy, the Committee seeks to achieve moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective, taking account of the forthcoming Treasury financing.

Alternative C

To implement this policy, the Committee seeks to actively promote moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective, taking account of the forthcoming Treasury financing.