MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Tuesday, January 11, 1972, at 9:30 a.m.

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

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Bernard and Molony, Assistant Secretaries
Mr. Hexter, Assistant General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Eisenmenger, Scheld, Solomon, Taylor, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account

Mr. Altmann, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Chase, Associate Director, Division of Research and Statistics, Board of Governors

Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Messrs. Keir and Pierce, Associate Advisers, Division of Research and Statistics, Board of Governors
Mr. Bryant, Associate Adviser, Division of International Finance, 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. Willes and MacDonald, First Vice Presidents, Federal Reserve Banks of Philadelphia and Cleveland, respectively
Messrs. Link, Parthemos, Andersen, and Craven, Senior Vice Presidents, Federal Reserve Banks of New York, Richmond, St. Louis, and San Francisco, respectively
Messrs. Bodner, Hocter, and Green, Vice Presidents, Federal Reserve Banks of New York, Cleveland, and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Kaminow, Research Officer and Economist, Federal Reserve Bank of Philadelphia
Mr. Sandberg, Securities Trading Officer, Federal Reserve Bank of New York

Chairman Burns welcomed Mr. John E. Sheehan, recently appointed to the Board of Governors, to his first meeting of the Federal Open Market Committee.[1/]

The Chairman then noted that Committee members had taken two actions in the interval since the previous meeting. First, on December 20, 1971, following the announcement that agreement on

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

exchange rates and related matters had been reached on December 18 at the Group of Ten meeting in Washington, the members had voted unanimously to amend the current economic policy directive issued on December 14 by adding the clause "while taking account of international developments" at the end of the last sentence.

> By unanimous vote, the action of members of the Federal Open Market Committee on December 20, 1971, amending the second paragraph of the current economic policy directive issued on December 14, 1971, by the addition of the words "while taking account of international developments" at the end of the last sentence, was ratified.

Secondly, the Chairman said, on December 23, 1971, by a vote of nine to one Committee members had approved the Manager's recommendation that the lower limit on interest rates on repurchase agreements specified in paragraph 1(c) of the continuing authority directive be suspended until close of business on the day of the Committee's next meeting.

> With Mr. Robertson dissenting, the action of members of the Federal Open Market Committee on December 23, 1971, suspending until close of business on the day of the next meeting of the Committee the lower limit on interest rates on repurchase agreements specified in paragraph 1(c) of the continuing authority directive, was ratified.

Mr. Robertson said he had voted against ratification of the action for the same reasons that had led him to dissent from the

action itself.[1/] He did not question the Committee's power to take the action it had on December 23. In his judgment, however, a vote to ratify such an action constituted a vote on the merits of the matter, and he was not prepared to modify his earlier position with respect to the merits of this action.

Chairman Burns remarked that unlike Mr. Robertson he would not interpret a vote to ratify an action taken between Committee meetings as implying any position with respect to merits. However, it was appropriate for individual members to vote according to their own interpretations.

The Chairman then said it was because he had become seriously concerned about the present stance of monetary policy that he had called a meeting of the Committee for today, one week in advance of the originally scheduled date of January 18. As the members would recall, it had been suggested at the December meeting that it might be necessary for the Committee to assemble before January 18 if the performance of the monetary aggregates did not improve sufficently. Despite energetic efforts on the

1/ In casting his negative vote on December 23, 1971, Mr. Robertson had filed the following statement with the Committee's Secretary:

> "The desired injection of funds into the market by the Federal Reserve should be through the outright purchase of U.S. Government securities rather than through repurchase transactions which actually constitute low-rate loans to security dealers. I am reluctant to increase the profits of dealers by providing them with low-cost Federal Reserve funds merely to avoid temporarily raising the price (lowering the yield) of Treasury securities by purchasing them outright."

part of the Desk, the rate of growth of the money supply--he was thinking chiefly of M_1--that the Committee had set as a major objective was not being attained. Indeed, there had been virtually no net growth in M_1 over the past four months. Worse still, total member bank reserves--an aggregate which surely was in the System's power to control--actually declined somewhat in the fourth quarter of 1971. That was a strange outcome in view of the System's determination to encourage monetary expansion.

In his view, Chairman Burns continued, it was important that the performance of monetary policy improve rather promptly. In that connection, he might note that he was scheduled to testify before the Joint Economic Committee on February 9. In essence, his task would be to give an accounting to the Congress on how the Federal Reserve had been contributing to the national objectives of economic growth and orderly reduction in the rate of inflation--that is, an accounting of the contribution the System had been making to the success of the new economic program which the President had announced on August 15. That program had the support not only of the entire Administration but also of both political parties in the Congress, as the passage of the Economic Stabilization Act and the Revenue Act of 1971 clearly attested.

While he was concerned about the standing of the Federal Reserve System with the Congress, the Chairman observed, the more basic question was whether the System's current monetary policy was well suited to the nation's economic needs. That question, he believed, was also troubling other members of the Committee. For that reason he proposed that the Committee depart somewhat from its usual procedures today, concentrating on domestic monetary policy and dealing briefly with foreign currency operations in the latter part of the meeting.

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:

> The incoming economic information of recent weeks, it seems to me, has been on the disappointing side. Thus, the unemployment rate in December inched upward, rather than downward as might have been expected. Nonfarm employment showed very little increase, after allowance for the return of striking coal-miners, and the number of jobs in manufacturing declined. The factory workweek--a leading indicator--did lengthen appreciably, and industrial production is estimated to have risen about 0.8 per cent, the same as in November. In both months, however, a substantial part of the increase in output resulted from the non-recurring, post-strike recovery in coal.
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> Retail sales also appear to have been a disappointment over the important Christmas season. The advance report for December, received yesterday afternoon, indicates a seasonally adjusted decline from November of 2 per cent. The weakness in total sales resulted in good part from the sharp drop last month in new car deliveries, which was to be expected

following the ending of the 90-day price freeze, but general merchandise sales also are reported to have fallen off markedly. The failure of Christmas sales to live up to expectations may have reflected inventory shortages in popular lines, of course, but the short-fall nevertheless contrasts with the experience of earlier cyclical recoveries, when holiday sales have often seemed to confirm a strengthening trend.

In any event, the recent evidence has led us to reduce our estimates of the fourth-quarter rise in GNP, from slightly over $22 billion four weeks ago to $19-1/2 billion currently. Our estimates of the rise in consumption expenditures have been cut back substantially, partly offset by an allowance for somewhat larger inventory accumulation. We still are estimating that there was a marked pickup in the real rate of growth last quarter, however, since it now appears that prices increased very little on average, under the influence of the freeze and retroactive termination of the auto excise tax. But I also should note that our GNP estimates do not yet take account of a downward revision in the figures for earlier in the year, which will not be released publicly by the Office of Business Economics for another week or so. The revisions, incorporating mainly the effects of the new series on retail sales and also retail store inventories, reduce the level of GNP by about $3 billion for the second quarter and $7-1/2 billion for the third. Almost all of this reduction comes out of real output and, using our present fourth-quarter estimates, the effect is to lower the indicated increase in real GNP in 1971 to 2.7 per cent, compared with the 3.1 per cent year-to-year gain that we were estimating four weeks ago.

Almost all economic projections, including ours, show substantial acceleration in real growth during 1972. In our case, real GNP this year is projected to rise by 6 per cent, with nominal GNP up 9-1/2 per cent or just about $100 billion. A rise of this magnitude is well supported, I believe, by the prospect that rising consumption will interact with increasing business efforts to restock inventories, producing substantial increases in disposable income. Business capital spending is also projected to be in a rising trend, in line with recent surveys and the stimulus of the investment tax credit, and the net export

balance is not expected to be the drag on domestic activity that it was during much of 1971. In addition, Federal fiscal policy is likely to be stimulative, notably through the impact on private disposable income of higher Government pay, lower tax rates, and a further rise in social security benefits at mid-year; and State-local government expenditures should continue to grow at a substantial rate.

Nevertheless, it is well to remember that these are projections, not facts. It is certainly not inconceivable that there could be further shortfalls in consumer spending and lags in business responses to a strengthening economy that would produce an appreciably less favorable economic performance for the year as a whole. Moreover, it should be noted that even the substantial acceleration in economic activity we are projecting would not bring us up to the point of reasonably full utilization of our productive resources by the end of the year. Rising productivity in association with expanding output and larger labor force growth as job opportunities improve are likely to slow the decline in unemployment; our projection is that the unemployment rate in the fourth quarter of 1972 will still average around 5.4 per cent. As for manufacturing capacity, we expect a rise in the utilization rate over the next year of only 3-1/2 points, to 77 per cent in the fourth quarter, despite an accelerating recovery in industrial production. Thus, there is ample room for even faster economic growth than we have projected in the year ahead.

These considerations lead me to the view that it is far preferable to err on the stimulative side in economic policy than to risk not being stimulative enough. If, in consequence, the economy is stronger than we are projecting, there will be room to accommodate this additional strength for a time without generating inflationary forces from the demand side that would worsen the problem of getting costs and prices under control. If, on the other hand, the economy turns out to be weaker than we have projected, the failure to have taken stimulative actions in timely fashion would lengthen the period during which there is an excessive waste of our available human and other resources. Therefore, the policy risks, as I see them for the present, run preponderantly in the direction that there may be inadequate, rather than excessive, stimulation.

So far as monetary policy is concerned, I believe that this balancing of the risks argues that the System do what it reasonably can to encourage a continuing free flow of credit, at gradually declining interest rates, into the whole array of domestic credit markets. Short-term interest rates have declined substantially since the last meeting of the Committee, but long-term rates have eased much less noticeably over the period. I would like now to see some carry-through of this greater ease to long-term markets, which would tend both to encourage lenders to speed up their commitment of funds and further increase the attractiveness of spending plans based on external finance.

Toward this end, I would be prepared to see a period of faster expansion in the monetary aggregates, including M_2 and bank credit, as well as resumption of substantial growth in the narrowly defined money supply. I would therefore urge the Committee to adopt the more expansive target path presented in the directive materials,[1/] which calls for an M_1 growth averaging 8 per cent in January and February. Because of the very low level to which short-term rates have fallen and the possibility that this may be in the process of generating excessively high rates of monetary expansion once again, I have some preference for the directive alternative specifying that the focus of operations be shifted to the provision of adequate reserves to achieve the Committee's objectives.

Chairman Burns suggested that members might wish at this point to put questions to the staff or bring to the attention of the Committee any significant new information they had about the economic and financial situation.

1/ The materials referred to included the alternative draft directives submitted by the staff, appended to this memorandum as Attachment A; and a document entitled "Alternative Operating Paragraphs for the Directive, and Background Information." The latter, which was referred to in subsequent discussion as the "white book" was prepared for this meeting in lieu of the blue book (the report, "Monetary Aggregates and Money Market Conditions).

Mr. Mitchell asked whether Mr. Partee thought the recent changes in methods of developing retail sales estimates had brought those figures up to a reasonable level of accuracy.

Mr. Partee replied that he could say only that Census Bureau officials thought their current estimating procedures were better than earlier procedures. The latest revisions, completed a few months ago, were part of a longer-run effort to improve the figures; the budget for retail sales data collection had been increased considerably for several years in a row and the Bureau had substantially expanded the resources it was devoting to the work.

Mr. Partee then said he would like to emphasize that the estimate he had mentioned of a 2 per cent decline in retail sales in December was based on the advance report and therefore was a highly preliminary reading. However, there were some other pieces of evidence that suggested weakness in sales during the Christmas season. First, on the basis of the Census Bureau's weekly figures--which employed a different sample from that used for the monthly advance report--the staff had been estimating a 1 per cent decline in retail sales from November to December. Secondly, reports from a large national chain organization indicated that sales in the general merchandise categories had been on the weak side during the holiday season, although reports from some smaller national

concerns showed sizable increases. Finally, unit sales of new automobiles had declined markedly in December, despite an upturn in the last ten days of the month.

In reply to further questions by Mr. Mitchell, Mr. Partee said there had been a large rise in consumer instalment credit outstanding in November, a month in which retail sales had also increased substantially. However, consumer credit estimates were not yet available for December--the month when it appeared that sales had weakened. The staff's earlier projection of consumer expenditures in the fourth quarter had been based in part on an expectation of a strong Christmas season; as a result of the indication of a weak December performance the projected rise had been cut back by about $4 billion. The first official GNP estimates for the fourth quarter probably would be published in about ten days.

Mr. Robertson said he had seen reports in the press of record sales in the post-Christmas week by a major department store in the Washington, D.C. area and by a national retailing chain. Also, it was his impression that in the last few months consumer credit outstanding had expanded more than it had in all of 1970.

Mr. Partee remarked that the volume of consumer credit had indeed risen markedly in the three months from September through November. However, he thought that development reflected the very

high rate of automobile sales during the period of the 90-day freeze; it was not at all clear that the December figures would show a correspondingly large rise. As to post-Christmas sales, he noted that data for the last week of December were included in the monthly estimates he had mentioned earlier. Also, sales at Washington department stores were not necessarily representative of national developments, since Washington was a high-growth area. That point, of course, would not apply to the national chain Mr. Robertson had mentioned. Finally, a large post-Christmas volume at retail stores might reflect promotional sales of inventories that had not moved earlier rather than strong consumer demand.

Mr. Maisel said he might make two points about retail sales data. First, the Census Bureau's advance monthly estimates had improved steadily over the past year, in the sense that their differences from subsequent estimates had become progressively smaller. In his judgment there was not likely to be much, if any, further improvement. Secondly, in interpreting figures on sales of the large national chain organizations, it was important to keep in mind that those organizations tended to open their new outlets in the early autumn to take advantage of the Christmas shopping season. It was his impression that the percentage rise in sales of major retailers this December had been a few points below their expectations.

Mr. Hayes said he had gathered from rather fragmentary data that post-Christmas retail sales in New York City had been strong.

Chairman Burns remarked that it should be possible to get an assessment by some large retail organizations of their December sales rather quickly by telephone. He asked Mr. Partee to have a staff member place such calls.

Mr. Hayes then referred to business prospects in general, and noted that at the previous meeting he had expressed agreement with the staff's judgment that the economic picture had improved somewhat. While conditions apparently had not changed significantly since mid-December, he would stress the net improvement that had occurred over the past two or three months. Also, the international settlement reached at the Washington meeting of the Group of Ten should have a positive effect on domestic attitudes, even though the expected reflows of funds to the United States had been slow in developing.

Chairman Burns concurred with Mr. Hayes' observation about the implications of the G-10 settlement.

Mr. Partee said he should note in connection with Mr. Hayes' remarks that the staff's central projection for 1972 was essentially unchanged from four weeks ago--namely, that current-dollar GNP would increase by about $100 billion and real GNP at a rate of

about 6 per cent. In the staff's judgment the most probable outcome was that there would be considerable strengthening in activity over the course of the year. Nevertheless, the experience with respect to retail sales in December was a useful reminder that the actual behavior of the economy could fall short of--as well as exceed--the projected behavior. It was also worth noting that even if the projection was realized the unemployment rate would still be comparatively high at year-end.

Chairman Burns commented that people sometimes forgot that there was uncertainly about the past as well as the future. The Commerce Department would be revising its GNP estimates for 1971 for the next three years, at the least. If one could trust the latest revisions to which Mr. Partee had referred, the earlier figures had overstated actual growth by a significant amount in the second quarter and by a considerably larger amount in the third quarter.

Mr. Morris recalled that for the past two months he had been critical of the Board staff's GNP projections--particularly for the fourth quarter of 1971 and the first quarter of 1972--because he thought the incoming data were not compatible with growth rates as high as those shown. The current projections struck him as more realistic. However, he believed the staff was overreacting to the discovery that its earlier optimism

was unwarranted since in his judgment the latest monthly figures suggested greater strength than earlier data had. He was referring particularly to such leading indicators as the average length of the workweek, prices of common stocks, new orders in manufacturing, and initial claims for unemployment compensation; to his mind, the recent behavior of those indicators was not consistent with a pattern of growing weakness. That some time series had not grown at the unrealistic rates originally projected was not grounds for pessimism at this point.

Mr. Mayo noted that at a number of recent meetings Committee members had commented on the disparity between the attitudes of economists and businessmen regarding the outlook for 1972, with the former much more optimistic than the latter. Lately he had found that while economists were not quite as optimistic as they had been earlier, businessmen were more optimistic. Even capital goods producers in the Midwest were displaying more confidence about 1972. That, he thought, was an important development.

Mr. Mayo added that he had no particular quarrel with the projections shown in the green book;[1/] as Mr. Partee had pointed out, they did not differ a great deal from those of four weeks ago. However, the staff's interpretation seemed to have a rather pessimistic tone which he would not have employed. On the specific question of retail sales, there was some evidence for Chicago

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

that November sales were better than usual, perhaps because unseasonably warm weather had led people to do their Christmas shopping early. If that were the case, December sales should be expected to look poorer than usual. It was true that the weather had been warm in December also, but that would have been beside the point to anyone who had already finished his Christmas shopping.

Chairman Burns said he was not sure about the net effects on retail trade of warm December weather, and Mr. Mayo commented that such weather was likely to have an adverse impact on sales of seasonal merchandise.

The Chairman then remarked that some research had been done on possible means of adjusting retail sales data for eccentric variations in weather as well as for normal seasonal fluctuations. The technical problems involved had not been solved, however, and a great deal more work was needed. It also would be desirable to have information gathered systematically about the quality of goods purchased--learning, for example, whether department store customers were shifting from bargain basement goods to higher quality merchandise. He was convinced it was technically feasible to gather qualitative information of that kind; indeed, he had done so at times in the past and had found the data to be of significant value in assessing the economic outlook.

Mr. Swan noted that, according to the white book, total reserves seasonally adjusted would rise sharply in January--at an

annual rate of 26 per cent under both targets I and II--and would then decline considerably in February--at a rate of 16 or 11.5 per cent, depending on the target adopted. He asked whether a similar pattern would appear in seasonally unadjusted data, or whether part of the swing was attributable to the adjustment process.

Mr. Axilrod responded that the swing shown was not particularly affected by the seasonal adjustments; rather, it reflected actual and anticipated movements of the various categories of deposits, allowing for the two-week lag in the calculation of required reserves. The February decline in total reserves was associated with an anticipated reduction in total member bank deposits--that is, in the bank credit proxy--and particularly with an expected sharp contraction in Government deposits.

Mr. Daane noted that the fourth-quarter decline in total reserves, to which the Chairman had referred earlier, was attributable wholly to a reduction in October when total reserves fell at a 16 per cent annual rate. In November and December, however, reserves had increased--at rates of about 8 and 6 per cent, respectively--and a large rise was now anticipated for January. He asked whether there were some special factors that accounted for the October decline.

Mr. Axilrod replied that an explanation of the October change could readily be developed in terms of the lagged movements in various categories of deposits. However, because the monthly series for total reserves was highly volatile, he thought it was

best to consider rates of change in terms of averages for longer periods.

In reply to further questions by Mr. Daane, Mr. Axilrod said that total reserves had increased about as much in September as they had declined in October. If September was considered along with the fourth quarter, total reserves would be found to have risen at a rate of about 3 per cent. Adding the projection for January to the fourth-quarter figures would yield a growth rate of about 6 per cent.

Mr. Mitchell asked what growth rate in total reserves would be associated with growth in M_1 at a normal rate--say, about 6 per cent.

Mr. Axilrod noted that at the time of the December meeting the staff was estimating that growth in M_1 at a 5 per cent rate in December and January would be associated with a 13 per cent rate of increase in total reserves over the two-month period. Most of that expansion in total reserves was expected to occur in January.

Mr. Partee remarked that in the staff's judgment M_1 would have to grow at a rate somewhat above 6 per cent in coming months if significant increases in interest rates were to be avoided.

Mr. Mitchell commented that if one considered longer time periods, such as calendar years, and excluded periods of severe monetary restraint, the historical record seemed to suggest that

a 6 or 7 per cent growth rate in total reserves might be considered normal.

Mr. Morris observed that total reserves had grown at about a 7 per cent rate over the year 1971.

Mr. Brimmer said he understood that the revisions in GNP figures for the second and third quarters to which Mr. Partee had referred would reduce the estimate for 1971 as a whole by about $2 or $3 billion. A revision of that magnitude was well within the range of historical experience, and when considered relative to the level of GNP--about $1,050 billion--it did not appear to him to be a matter of great concern.

Chairman Burns said that while he agreed in general with Mr. Brimmer's statement he would note that in the current instance the downward adjustment was about $7-1/2 billion for the third quarter, compared with $3 billion for the second. If one assumed that the revised figures were closer to the truth than the unrevised--and after many years of working with the numbers he tended to take such revisions with a grain of salt--it appeared that the size of the error had widened as the year progressed.

Mr. Brimmer then remarked that the staff's latest GNP projections involved a little less growth in the near-term than the projections of four weeks ago, and a little more growth later in 1972. In general, however, the staff still expected the economy to make progress over the course of the year. The question

for the Committee to consider was whether the indicated rate of advance was fast enough. But it seemed to him that the economic outlook was not dramatically different today from what it had been in December.

Mr. Partee said he agreed with Mr. Brimmer's observation. The projected GNP growth rates had been lowered a little for the first half and raised a little for the second half, but the average for the year was virtually unchanged. His point was that there was a particularly great exposure at this time of the year to shortfalls from projected levels which might tend to carry through the whole year. He should also note that the 1971 level of GNP would be reduced when the new revisions for the second and third quarters were incorporated. If that lower level had carried through to the fourth quarter, which seemed probable, it would be harder arithmetically to make the $100 billion gain projected for 1972 compared with 1971.

Mr. Brimmer said his third observation related to the contents of the white book. He wondered why the staff had departed from its earlier practice of discussing the outlook for the monetary aggregates for at least a quarter ahead and of presenting projections for such periods. The discussion of prospective developments in the white book was confined to January and February, with no reference to the first quarter, and it was limited to possible targets--that is, to growth rates the Committee

might like to see, as opposed to the growth rates the staff thought would develop given particular money market conditions.

Chairman Burns remarked that while Mr. Axilrod no doubt would comment on that subject later in the meeting, he (the Chairman) should note that he might have had some influence on the staff's procedures. He had been examining the record of staff projections of the aggregates and found it disturbing; the projections were not good. He would not go into details at this point, but he would say that he did not mean to imply any criticism of the staff, which had been doing excellent work. The difficulties with the projections were a consequence of deficiencies in the present state of knowledge.

Mr. MacLaury said he had a good deal of sympathy with Mr. Brimmer's comments about the pattern of GNP growth, and with Mr. Mayo's view that the change since mid-December was not so much in the projected growth rates as in the staff's interpretation of the numbers. The critical question now was whether the new retail sales series would call for a downward revision not only in the published figures for GNP growth in the second and third quarters but also in the staff's estimate of the probable fourth-quarter gain. With respect to the change in the fourth-quarter estimates from four weeks ago, he had been impressed by the fact that--even though the figure for personal consumption expenditures had been reduced somewhat--the estimated rate of

growth in real GNP had been lowered only slightly, from 5.9 to 5.7 per cent. Moreover, it appeared that the price advance was smaller than had been expected earlier; the rise in the GNP deflator in the fourth quarter was now shown as 1.5 per cent, compared with 2.4 per cent four weeks ago. Unless the fourth-quarter estimate of real GNP growth was to be revised downward, he would not be inclined to share the staff's more pessimistic attitude. He did not see why Committee policy at this point should be particularly influenced by the level of retail sales in the first post-Christmas week.

Mr. Partee observed that since August the Census Bureau had been preparing its retail sales estimates only on the new basis, and those data were already incorporated in the staff's estimate of GNP growth in the fourth quarter. Hence, no further revisions would be made in the estimate of fourth-quarter performance as a consequence of the change in method of estimating retail sales. He might note that it was the absence of data on the old basis for September and later months that had led the Commerce Department to decide to publish revisions in the GNP figures for earlier quarters shortly after the end of the year; normally, such revisions were published only in July.

According to the latest estimates, Mr. Partee continued, retail sales rose by 1.8 per cent from the third to the fourth

quarter, or at an annual rate of about 7.2 per cent. The 90-day freeze had been quite successful in keeping down price increases, and the rise in deflated sales appeared to have been on the order of 5 per cent. That was not a bad showing, although one should allow for the fact that new car sales were temporarily very high during the period of Phase I.

More generally, Mr. Partee said, it seemed that prices had advanced relatively little from the third quarter to the fourth. In particular, the expected surge in prices at the end of the 90-day freeze apparently had not materialized. It was possible, however, that the surge had simply been delayed until January. For one thing, under the rules laid down by the Price Commission retailers were not permitted to raise prices within the guidelines until they had posted their base-period prices. However, they were not required to post prices until the first of the year and very few had posted them earlier.

Mr. MacLaury said the essential consideration was that, whatever might happen to prices in January, the GNP estimates for the fourth quarter had been revised downward mainly because prices--not real output--had risen less than expected.

Mr. Partee observed that the fourth-quarter gain in real GNP of 5.7 per cent currently estimated, while not as large as the gain the staff had been projecting in late summer

and early fall, would represent a substantial acceleration from the rise of 2.7 per cent now estimated for the third quarter by the Commerce Department.

Mr. Francis recalled that at the last meeting he expressed some concern over the fact that the St. Louis Bank's projections of GNP for 1972 had been adjusted downward in light of the events of the preceding several months. Developments of the last four weeks had not produced any change in that situation, and at the moment he found it difficult to believe that GNP would increase by $100 billion in 1972. Also, he had the impression from the newspapers that some people who had been freely predicting a $100 billion increase earlier had now become a little more cautious. He was quite concerned that the events of the last few months were going to result in a smaller rise in real activity in 1972 than might have been hoped for.

Mr. Heflin said he had been puzzled by the suggestion at the last meeting that an interim meeting might be necessary if M_1 were growing too slowly. It was not clear to him that the Committee could achieve "instant M_1."

Chairman Burns responded that the Committee could achieve an instant increase in bank reserves. If the growth in reserves was not associated with a rise in M_1 it would almost certainly produce an increase in M_2. By bringing about the reserve increase the System would have done what it was capable of doing.

Mr. Heflin then noted that the white book suggested omitting the phrase "over the months ahead" from the second paragraph of the directive "if the Committee wishes to emphasize prompt attainment of a desired rate of growth in M_1." He asked whether Mr. Axilrod would expect any action the Committee might take today to be reflected in the January data--and if not, in the February data--for either M_1 or total reserves.

In reply, Mr. Axilrod said the white book language Mr. Heflin had quoted was meant only to suggest that the Committee might prefer to specify a target growth rate for M_1 for January and February rather than over some longer interval. In his judgment, the growth rates shown for total reserves under targets I and II were attainable, at least in terms of averages for the two months. Also, such growth rates in total reserves would be consistent with the associated target rates of growth in M_1-- 6 per cent under target I and 8 per cent under target II. Since one could not predict with confidence that a given increase in reserves would produce some particular mix of deposits, there undoubtedly would be some slippage, and the average growth rate in M_1 in January and February might well differ from the target rate. However, if reserves were supplied at the indicated rates it was quite likely that M_1 would expand at a reasonable pace over the two months.

Mr. Mitchell referred to Mr. Brimmer's earlier comment that the revisions in GNP estimates for the second and third quarters

of 1971 were not of great concern since they were small relative to total GNP. However, the revisions appeared considerably more significant when viewed in relation to changes in GNP, rather than to levels; the cutback being made from the previously estimated third-quarter increase of about $18 billion did not strike him as an unimportant development.

Mr. Mitchell then referred to Mr. MacLaury's comments about the reduction in the staff's estimate of the growth in current-dollar GNP for the fourth quarter. Like Mr. MacLaury, he was more concerned about real than about dollar GNP. However, he was not greatly reassured by the indication that the earlier overstatement had been mainly in prices rather than in real output, since the estimates of real GNP were much less reliable than those of current-dollar GNP. He found the reduction in the dollar figures disquieting, particularly because it seemed to be associated with a change in the outlook for retail sales. On the latter subject, he was unhappy at not having enough information about the recent revision in the series.

Mr. Maisel said he had intended to make the same point as Mr. Mitchell had with respect to the GNP revisions. At the last few meetings he had expressed the view that the staff's projections underestimated the amount of slack likely to exist in the economy around the end of 1972, and he noticed that in the latest projections they had shaded up the figures for unemployment and reduced

those for capacity utilization in manufacturing. If the staff projections were accurate the Committee had more freedom to err in the direction of monetary ease than in the direction of restraint.

Mr. Maisel then noted that the staff's projections for 1972 were based to a large extent on rather optimistic assumptions about the course of consumer expenditures. Current data on retail sales were important because they provided the means for evaluating those assumptions as the year progressed. Unlike the current data bearing on plant and equipment spending--which seemed to support the assumptions in that area--the latest figures on retail sales suggested to him that the staff's estimates of consumer spending were too optimistic.

Mr. Coldwell observed that while there might have been some disquieting elements in recent economic developments he was reluctant to accept at face value the indications that retail sales had been weak recently. Developments in his District, at least, did not bear out such indications. Some of the District stores reported that sales of general merchandise in December 1971 were 20 per cent above the level of a year earlier. Over the full year 1971 relative to 1970, sales at stores in the Eleventh District rose 7 or 8 per cent, which was considerably more than the advance in prices.

On the other hand, Mr. Coldwell remarked, the continuing high level of unemployment in the District was a significant adverse factor. That unemployment had been fostered initially by retrenchment in defense and other Federal programs, but it was being sustained by uncertainties related to the new economic controls and to problems in the international financial area, and by the cutbacks in Federal employment. In some parts of the District--particularly in Dallas and San Antonio--it appeared that employment was not growing normally mainly because of the Government's hiring freeze.

Mr. Coldwell said he doubted that much could be done through monetary policy to deal with unemployment of that type. At the same time, like some others he questioned whether a $100 billion increase in GNP was a reasonable expectation for 1972.

Mr. Hayes referred to Mr. Brimmer's earlier comment about the contents of the white book and said he hoped the staff would indicate at some point what its projections of M_1 for January and February would be on the assumption of no change in money market conditions.

Chairman Burns said he had found the Committee's discussion to be quite interesting. For the most part, however, it had

focused on very recent developments, in the last month and quarter. He would like to comment on the state of the economy, as he saw it, from a somewhat longer perspective in an effort to throw light on the problem facing the Committee.

The Chairman noted that the current recovery had been under way since November 1970, a little more than a year. After a year of recovery, the unemployment rate was still about 6 per cent and the industrial production index was still almost 4 per cent below its previous peak. After a year of recovery, the first preliminary indications of a strengthening in business capital expenditures were only now appearing and there was as yet no evidence that businessmen were beginning to rebuild their inventories.

As a student of the business cycle, the Chairman said, he found that situation to be most unusual. A comparison of detailed figures for the present recovery and earlier recoveries in the postwar period made it clear that this recovery was the most sluggish by far. As an example, he might cite the figures on the declines in the unemployment rate during the twelve-month period following the troughs of successive business cycles. During the year after the recession trough of August 1954, the unemployment rate dropped 1.8 percentage points; after the April 1958 trough it fell 2.2 points; and after the February 1961 trough it fell 1.4 points. During the current recovery, in

contrast, the unemployment rate had risen 0.2 of a percentage point. Much the same story was told by other comprehensive economic indicators. The capital goods industries thus far had scarcely participated in this recovery, whereas historically business capital investment had been the driving force of economic expansion. And the sharp upturn of inventory investment--which historically had come at the very beginning of a cyclical upswing--had been absent.

The Chairman then noted that Mr. Daane had just returned from the January Basle meeting. He invited Mr. Daane to report on any aspects of the meeting that were relevant to the Committee's deliberations on domestic monetary policy.

Mr. Daane said he would confine his comments to certain relevant points made in the governors' discussions on Sunday afternoon and evening. In the afternoon session all of the governors addressed themselves to the question of why there had not been a reflow of dollars following the Washington agreement of the Group of Ten--which, they noted, had been well received in their respective countries. The principal explanations offered were, first, that considerable market uncertainty existed regarding the durability of the Washington agreement on exchange rates; second, that with wider margins and the dollar at the ceiling against most key currencies, there was little incentive to shift funds back to the United States; and third, that interest rates offered no incentive

for a shift, since the dollars involved were invested abroad at attractive rates relative to those now available in the United States. He might mention in passing a comment by the Swiss representative to the effect that there had been a considerable outflow of intermediate- and long-term funds from his country but that short-term funds had not moved.

On Sunday evening, Mr. Daane continued, the governors focused specifically on the question of U.S. interest rate levels. They indicated that from their viewpoint--and recognizing that they were not in a position to assess the needs of the U.S. economy--it would be desirable for the United States to proceed cautiously in easing monetary policy and in undertaking any further liberalization of capital controls. He thought that attitude, which they had asked him to convey to the U.S. authorities, was relevant to the Committee's discussion today.

In reply to a question by Mr. Robertson, Mr. Daane said the Europeans were particularly concerned about the possibility of further dollar inflows to their countries--inflows which might be stimulated by a liberalization of the U.S. capital controls program or by a further down-drift of U.S. interest rates--because the dollar was an inconvertible currency at the moment.

Mr. Maisel asked whether it was not in the interest of the United States for foreign central banks to maintain large holdings of dollars.

Mr. Daane replied that the size of foreign dollar holdings had implications for the viability of the new system of exchange rates agreed upon at the Washington meeting of the Group of Ten. A "normal" orderly reflow would be associated with a strengthening of the dollar and would make the new central rates appear more sustainable.

Chairman Burns then said it would be helpful if Mr. Solomon would comment on the degree to which the Committee should take international factors into account in deciding on monetary policy for the period immediately ahead.

Mr. Solomon observed that the question was a difficult one. Instead of attempting to provide a simple, clear-cut answer, he would indicate some of the key considerations that came to mind. First, in his view at least, the fact that there had not been a large reflow of dollars from foreign central banks should not be particularly disturbing to U.S. monetary authorities or to foreign authorities. Early in the period following the December 18 settlement there had been some reduction in the dollar holdings of foreign central banks, and since then there had been little or no net accumulation. Because the balance of payments position of those countries had been in basic surplus during the period--as the counterpart of the deficit in the basic U.S. payments balance--some return flows of dollars must have occurred. If that situation were to continue throughout the year--i.e., if the deficit expected

in the basic U.S. payments balance were roughly offset by a persisting slow reflow of dollars, with no net increase or decrease in dollar holdings of foreign central banks--the position of the United States would be a rather comfortable one.

However, Mr. Solomon continued, a renewed accumulation of dollars by foreign central banks probably would have unfortunate psychological effects. Specifically, participants in the foreign exchange markets might come to believe that the December agreement was not viable, and the uncertainties and tensions that had prevailed between August 15 and December 18 might arise again. Among other consequences, such a development could have effects on U.S. business activity. If short-term interest rates in the United States, which already were quite low, fell sharply further and stayed down for a considerable period of time, renewed outflows of dollars would become much more likely.

Mr. Solomon said he might mention one other consideration. While the Basle group of central bankers would not like to see U. S. short-term rates decline, presumably they also would not want to see a setback to the economic recovery here. He thought the Europeans would understand if the Federal Reserve fostered lower domestic interest rates because it was concerned about the strength of the economy.

Mr. Daane said he agreed with Mr. Solomon's concluding comment. The Europeans were faced with actual or incipient

recessions in their own countries, and they probably would be unhappier about a failure of the U.S. economy to strengthen than about a further modest down-drift in U.S. interest rates.

In response to a request for comment, Mr. Bodner said he might note that the reasons for the lack of a reflow thus far had also been discussed at the meeting of experts that preceded the governors' sessions at Basle. In the judgment of the experts, the single most important cause of the delay in the return of funds to the United States was uncertainty about the durability of the new exchange rate structure. Interest rates were considered to have been less important so far, but there was concern about any further declines in short-term rates in the United States. The Group of Ten countries had been willing to agree to the new exchange rate structure, along with an inconvertible dollar, in part because they had assumed that agreement would be followed by a return flow of dollars.

Mr. Bodner added that the experts from the Common Market countries had spent much of the weekend trying to work out a system of market intervention using their own currencies--avoiding use of the dollar to the extent possible--to maintain their cross-rates within a narrow band of 1-1/2 to 2 per cent. He thought that effort partly represented contingency planning, in the event they were faced with substantial new inflows of dollars.

Chairman Burns said he believed a significant point had been overlooked in the discussion of foreign attitudes. As Mr. Daane had indicated, European countries were faced with an actual or incipient recession, and it seemed highly unlikely that their governments and central banks would sit by and take no countercyclical action. Putting aside the question of U.S. interest rates for the moment, he asked what the Europeans--particularly those faced with recessionary tendencies at home--would say about the likely course of interest rates in their countries.

Mr. Daane replied that the Germans, who were as concerned as any about a recession, no doubt would reply that interest rates had declined in their country and that they had taken monetary policy actions that would lower rates further. He had some doubts as to whether they were pressing hard enough, and that question might well be put to them in future discussions. At the Basle meeting the British had described the fiscal policy measures they had taken. In that connection, he might note that in discussing U.S. policy they had suggested greater reliance on fiscal measures, and less on monetary, in order to minimize the impact on international interest rate differentials. He had not commented on that suggestion because he did not know what the Administration's budget proposals would be.

Chairman Burns remarked that, from the way the budget figures for fiscal 1972 were shaping up, it seemed safe to say that many people would be deeply disturbed when they were published. The budget for fiscal 1973 would also be disturbing, but the concern about that year might be lessened by the fact that it began six months and ended eighteen months from now.

Mr. Brimmer noted that according to the white book the staff was proposing to eliminate the reference to international developments from the second paragraph of the directive because "reflows of funds from abroad have not been showing signs of becoming a disturbing influence on monetary policy." He had some question about that reasoning, and he noted that the Manager's approach to open market operations in the recent period had reflected an expectation that reflows might develop. In any case, he wondered whether or not the staff now expected any reflows in coming weeks to remain modest.

Mr. Solomon replied that, as he had noted earlier, the fact that European central banks were not accumulating dollars suggested that some reflows were already occurring. He found it very difficult to assess the prospects for the period before the next meeting, but his best guess was that there would not be a dramatic pickup.

Mr. Bodner said he agreed with that view with one qualification--large reflows could develop suddenly if legislation changing the official U.S. price of gold was enacted. Legislative action on gold seemed to be the event for which many market participants were waiting before returning funds to the United States.

Chairman Burns said it was rather unlikely that the legislation in question would be enacted within the next four or five weeks. The Administration wanted to have some evidence of progress in trade negotiations before it submitted its bill to Congress, and even after it did so hearings would still have to be held by the banking committees of both the House and the Senate. However, he was confident the legislation would be enacted in due course. Congressional leaders of both parties had endorsed the type of bill contemplated when the President had reviewed it with them.

Mr. Daane commented that like Mr. Brimmer he would question the desirability of omitting reference to international developments from the second paragraph--particularly if, as Mr. Bodner suggested, the enactment of gold legislation might trigger reflows. Even apart from that consideration, he was doubtful about the desirability of omitting such a reference only one month after a very important international settlement had been reached.

Mr. Mitchell asked Mr. Bodner whether one of the factors contributing to doubts in the exchange market about the viability

of the settlement was apprehension that the United States might finally decide not to change the price of gold.

Mr. Bodner replied that there seemed to be some uncertainty in the market as to whether the gold price would in fact be changed, or at least whether legislation would be enacted in the form proposed. In particular, there was some concern about a possible impasse in the trade area. But that was only one of the considerations producing the present uncertainty. In general, the market was viewing the settlement as only a tentative agreement.

Mr. Daane noted that Minister Schiller of Germany had publicly described the Washington agreement as "a very fragile work of art."

Mr. Solomon remarked that it might be useful to recall a bit of history relating to the British devaluation in 1967. For months after that devaluation there were grave doubts in the exchange market as to whether it had had any effect on the British payments position or was likely to have such an effect. As it turned out, the devaluation had had an enormous effect--but only after a considerable lag. Similarly, it would become clear over time that the recent realignment of exchange rates had had a significant impact on the U.S. balance of payments.

Mr. Partee then reported that he had just been informed of the results of the telephone calls to two large national retailers

which the Chairman had suggested earlier in today's meeting. Neither of the companies called had been able to report its sales on a seasonally adjusted basis. Both respondents advised that their December sales were not disappointing relative to expectations. The economist for one company reported that they had been expecting a narrowing of the gains in sales relative to last year as they proceeded through the Christmas season, but in fact they had experienced a little widening. In the week after Christmas their sales were exceptionally strong. At the same time, their year-end inventories reportedly were well above target. The representative of the second firm advised that their pre-Christmas sales were about 8 per cent above a year ago, in line with expectations, and sales in the post-Christmas week were up 8.3 per cent. He characterized the general view of their management in the following terms: "Sales are in an upward trend, but the movement is not spectacular."

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period December 14, 1971, through January 5, 1972, and a supplemental report covering the period January 6 through 10, 1972. Copies of both reports have been placed in the files of the Committee.

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

System open market operations over the period since the Committee last met were conducted during a time of year-end churning in the money market and a time of considerable uncertainty about reflows of funds from abroad following the international currency settlement on December 18. Operations were directed toward a substantial easing of money market conditions as the December growth of the narrowly defined money supply appeared to be well below the Committee's desires. As the period progressed, the strategy of open market operations shifted from the temporary supplying of reserves through repurchase agreements towards outright purchases in the market as the widely heralded reflow of funds from abroad failed to materialize in significant size.

The impact on security markets of vigorous System action to supply reserves was to drive interest rates lower, particularly in the shorter end of the market. This was in sharp contrast to the general expectation at the time of the last meeting that there would be substantial upward pressure on Treasury bill rates. Considerable uncertainty continued to persist in the markets, however, as many market participants--in light of what they saw as generally favorable economic developments other than the unemployment rate and in light of the general state of bank and nonbank liquidity--found it hard to believe that the Federal Reserve should be pushing as hard on the Federal funds rate as we were in fact doing.

The sharp downward move in short-term rates was amply illustrated in yesterday's Treasury bill auction when average rates of 3.11 and 3.37 per cent were established for three- and six-month bills respectively, down 83 and 77 basis points from the rates established in the auction just preceding the last Committee meeting. Markets for long-term securities also improved over the period, although less dramatically. In fact, it is worth noting that while dealer positions in Government securities maturing in more than one year have declined by about $1.2 billion since their mid-November peak, official purchases (Federal Reserve and foreign) amounted to about $1-1/2 billion. With dealer positions in coupon issues still relatively high at over $1 billion, it is not clear how receptive the

market would be to a long-term Treasury offering, as was indicated by the negative market reaction to a news story last Monday of a possible advance refunding.

As noted earlier, open market operations were directed toward a significant easing of money market conditions. Since year-end we have been aiming, with varying degrees of success, at a Federal funds rate of 3-5/8 per cent--the lower end of the range specified by the Committee at its last meeting. The money market was quite volatile over the period, as year-end churning made it difficult for banks to judge their money positions day by day, and Federal Reserve staff forecasters had comparable problems in predicting the effects of market factors on bank reserve positions. As you know, both the Treasury and the Federal Reserve had made contingency plans to help cushion the impact of the expected massive reflow of funds from abroad on security markets--particularly on the Treasury bill market. When the reflow proved quite modest, we found ourselves in the awkward position of meeting a large reserve need without the expected automatic supply of Treasury bills from foreign accounts. And the Treasury found itself with an embarrassingly large cash balance at year-end.

In fact, since December 18, the Treasury has paid off on balance only about $400 million of special certificates issued to foreign monetary authorities, and we were able to acquire net only about $280 million bills directly from foreign accounts. Both results fell far short of what had been anticipated. In addition, foreign central banks bought, on balance, $1.3 billion of bills in the market--a sharp contrast to the heavy sales that had been expected. With the Treasury balance in tax and loan accounts very high, the Treasury decided to raise their balances at the Reserve banks to a high $2-1/2 billion level--an action that, of course, absorbed reserves. While this action was quite understandable in light of the circumstances, it did complicate open market operations over the period. Over the past week the Treasury balance has been running $400-$700 million above expectations, further complicating the reserve picture.

Early in the interval we concentrated our operations on a temporary supply of reserves through repurchase agreements, saving our ammunition to buy outright from foreign accounts once the expected reflow got under way.

As it became increasingly clear that the reflow was not going to develop as quickly as expected (in recent days, in fact, foreign central banks have experienced a substantial inflow of dollars) operations were shifted to outright purchases of Treasury bills and coupon securities. All in all, net purchases amounted to $950 million Treasury bills, $217 million Treasury coupon issues, and $318 million Federal Agency issues. In addition, $7.7 billion in repurchase agreements were made at rates ranging from 3-5/8 per cent to 4-1/8 per cent.

As the written reports indicate, the Committee's decision to suspend the lower rate limitation on repurchase agreements was invaluable to the Desk. Without it, we could not have met the volatile reserve needs that developed on certain days, particularly on December 29 when a record $2.5 billion of repurchase agreements were made. As has been explained elsewhere, the suspension was necessitated by the plethora of corporate and other funds available to dealers at very low rates during much of the period.

I might add that today the Desk is in process of supplying reserves through repurchase agreements--using that instrument because the statement week is nearly over--at a rate of 3-1/2 per cent. When the lower rate limit on repurchase agreements was suspended it had been understood that the Desk would not use the additional leeway so provided to set rates below 3-5/8 per cent without prior notification to the Committee. However, since the latest auction rate on three-month bills was 3.11 per cent, a 3-1/2 per cent rate on repurchase agreements was well above the lower limit that would apply had there been no suspension.

Looking ahead, projections indicate a need for the System to supply reserves in the forthcoming statement week, and then to absorb reserves as required reserves fall off in the usual seasonal pattern. It is hard to judge what may happen to foreign central bank dollar holdings--but should a reflow develop, it will certainly tend to complicate open market operations. And with their cash balance expected to decline rather sharply in the weeks ahead, the Treasury will be in a poorer position to cushion the impact of a reflow in the Treasury bill market.

I believe that no useful purpose would be served by commenting on the proposed directives submitted by the staff until the Committee has had a chance to discuss them. I should point out, however, that a further

easing of money market conditions will have an obvious impact on the security markets. Market apprehensions that the System may be about to repeat the pattern of easing and then the firming of money market conditions that occurred in March or April of 1970 and 1971 may prevent participants from taking on an overly speculative position--but we can never be sure of that. If the staff expectations are right that M_1 will be rising sharply as the first quarter progresses and that some firming of money market conditions will ensue, we should be prepared for a fair amount of market disturbance. The timing of the Treasury's February refunding could turn out to be quite unfortunate in that respect.

Mr. Axilrod then made the following statement:

First I might comment briefly on the ways in which the content of the white book prepared for today's meeting differs from that of the customary blue book. One obvious difference is that the white book is shorter, and it includes less material on projected relationships among monetary aggregates and interest rates. That can be explained in part by the fact that the decision to advance the date of today's meeting left the staff with less than the usual amount of time for its preparation. But in addition it reflects, as will be explained later, an effort to clarify the distinction between projections and targets. The white book differs from the blue book also in presenting for Committee consideration not only alternative targets for open market policy but also alternative operating procedures for achieving those targets.

The alternative targets shown--labeled "I" and "II"--might be identified conveniently in terms of the growth rates given for M_1 in January and February, which are 6 per cent under target I and 8 per cent under target II. The alternative operating procedures are labeled "A" and "B" and are associated with similarly labeled alternatives for the language of the second paragraph of the directive. Either operating procedure can be employed in conjunction with target I or II--or whatever other target the Committee might decide upon.

Under the alternative A procedure, the Desk would continue to operate as it has in the recent past--focusing on money market conditions as the key to day-to-day operations, while paying some limited attention to member bank reserves. It is suggested in the white

book that if the Committee adopts the A procedure it might wish--in view of the persistent shortfalls of M_1 from desired growth rates--to instruct the Desk to reduce the Federal funds rate in stages from the 3-5/8 per cent rate at which it has recently been aiming. Specifically, it is suggested that the funds rate be reduced to the neighborhood of 3-1/4 per cent in the first week following the meeting and to 3 per cent in the second week, unless there is a sudden surge in M_1. The white book also notes the possibility that the funds rate will later have to be raised substantially to keep M_1 from exceeding its target rate, particularly if that is the 6 per cent rate of target I but possibly also if the 8 per cent rate of target II is adopted.

Under the alternative B procedure considerably more emphasis would be placed on reserves. The Manager would have at hand data on the weekly path of total reserves, seasonally unadjusted, that is expected to be consistent with the target growth rates for monetary aggregates decided upon by the Committee. Each week he would also have estimates of the likely course of reserves as a result of the workings of market factors, and he would decide on operations to supply or absorb reserves that week depending on whether it appeared that there otherwise would be a shortfall or excess relative to path. The target path itself would be adjusted each week to take account of unexpected changes in Treasury and interbank deposits and perhaps large CD's and also in bank demands for excess reserves. And, as suggested in the white book, the Committee might want to include a proviso limiting the range of fluctuation in the Federal funds rate.

The white book does not include explicit projections of the aggregates for any given set of money market conditions, although a sense of what such projections would be is implied by the comments on the changes in money market conditions that are likely to be required to keep the aggregates on target paths. Projections of the aggregates were omitted partly to avoid the kind of confusion between projections and targets that has often arisen in the past. Also, as the Committee knows, recent projections have been subject to substantial errors.

It might be helpful if, before responding to the questions raised earlier about the staff's current projections, I were to comment briefly on the means by which such figures are developed and on the magnitude

of their errors in a recent period. The sets of projections for the various key aggregates typically shown in the blue book are based on independent estimates made by different staff members employing different techniques. One set is developed by applying the Board's monthly econometric model. I might note in passing that lately some use has also been made of a weekly model, but the results thus far have proved less reliable than those of the monthly model. Another set of projections is developed by staff members using wholly judgmental methods. A senior staff member--usually myself--considers these preliminary figures and arrives at tentative decisions regarding the projections to be shown in the blue book, which are then reviewed with the staff group responsible for the content of that document.

To provide an idea of the size of the errors, I will compare the actual annual rate of growth in M_1 for calendar quarters with the projections contained in the blue book distributed around the middle of the first month of the corresponding quarter. Also, I will focus on the last three quarters of 1971; during the preceding four quarters, the blue book projections were quite accurate, tending to differ from the actual growth rates by only about one percentage point.

In the second quarter of 1971 M_1 grew at an annual rate of 10-1/2 per cent, compared with a 7 per cent rate projected in the blue book. Incidentally, for that quarter the monthly econometric model had projected growth at a rate of 10 per cent. In the third quarter of 1971 M_1 grew at a rate of 3-1/2 per cent, well below the blue book projection of 9 per cent. For that quarter the econometric projection was further off the mark--12-1/2 per cent. For the fourth quarter, growth in M_1 is currently estimated at a rate of about 1/2 per cent, compared with the blue book projection of 3 per cent and the econometric projection of 1-1/2 per cent.

I might note that unanticipated exogenous factors probably affected the results for the third quarter. Specifically, the announcement of the new economic program on August 15 very likely resulted in a sharp reduction in the demand for cash balances relative to income.

It was against that background of large misses in the recent projections that the decision was made to omit the current projections of the aggregates from the white book and to focus on targets. As to the

nature of the current projections, on the assumption that prevailing money market conditions--typified by a Federal funds rate around 3-5/8 per cent--are maintained, the econometric model suggests that M_1 will grow at a rate of 10 per cent over the first quarter of 1972 and at the somewhat faster rate of 12-1/2 per cent on average in January and February. The staff's judgmental projections of M_1 are lower; they suggest growth in the first quarter at a rate of 7-1/2 per cent and in January and February at rates of 6 and 10 per cent, respectively.

While neither set of projections can be expected to be precise, together they imply that the demand for money will be stronger in the first quarter than in the fourth, and that interest rates are likely to begin moving up from current levels at some point in the first quarter--particularly if growth in M_1 in January and February is kept to the 6 per cent rate of target I, assuming that nominal GNP expands as rapidly as the staff has forecast. An operating procedure that places stress on reserves, such as that of alternative B, could, of course, be associated with a proviso clause that served to constrain the rise in interest rates to dimensions the Committee was willing to countenance.

In response to a question by Mr. Brimmer, Mr. Axilrod said he did not have at hand data on misses in projections of M_2 and total reserves, but he thought they could be of roughly the same order of magnitude as those for M_1. Any errors in projections of deposits would also be reflected in the reserve projections, since those projections were developed jointly for particular assumed levels of the Federal funds rate.

Mr. Daane observed that the language of alternative A, indicating that the Committee sought to promote "the degree of ease in bank reserve and money market conditions essential to greater growth in the monetary aggregates," was similar to that

which he had proposed at the previous meeting and which the Committee had adopted. In proposing that language he had suggested that it be interpreted as calling not for attaining any specific level of the funds rate, but rather for "erring on the side of ease" in order to increase the growth rate of the monetary aggregates. He asked why alternative A was interpreted in the white book solely in terms of target levels for the Federal funds rate.

Mr. Axilrod said he agreed that in adopting its December directive the Committee had intended to have the Manager give some weight to variables other than the funds rate, including bank reserves. However, it had also agreed on an interpretation of the directive language that involved a highly specific instruction in terms of the Federal funds rate. Specifically, the Manager had been told to ease the funds rate progressively down from the then-prevailing level of about 4-1/4 per cent to 3-3/4 per cent if necessary to encourage growth in M_1 at a rate of 5 per cent in December and January, and to aim at a 3-5/8 per cent funds rate if it appeared that M_1 was growing at a rate below 4 per cent.

Chairman Burns said it was his recollection that the Committee had devoted a great deal of time at the December meeting to arriving at a consensus regarding the appropriate range for the Federal funds rate, and to specifying the precise circumstances under which the Manager was to aim at particular levels of that rate.

Mr. Daane observed that that was his recollection also. He thought the Committee had focused too narrowly on the funds rate at the December meeting and he was disturbed by the fact that the discussion of alternative A in the white book invited the same sort of focus at this meeting. He would prefer to interpret A as calling simply for somewhat greater liberality in supplying reserves.

Chairman Burns agreed that the alternative A language would permit the interpretation Mr. Daane favored. He went on to say that the staff had provided him with another summary of the errors in its projections of M_1 for the past year which he might share with the Committee. Like Mr. Axilrod's summary, it involved a comparison of the actual growth in M_1 over calendar quarters with staff projections. However, it was limited to the projections shown in the blue book rather than covering also those developed with the econometric model; and it utilized the first projection made for each quarter, rather than that made near the middle of the first month of the quarter. According to the summary, the growth rates of M_1 projected for the first and second quarters of 1971 proved to be 2.1 and 4.6 percentage points, respectively, below the actual growth rates. For the third and fourth quarters the projected growth rates were 3.8 and 3.5 percentage points above the actual rates. Relative to the Committee's target rates,

which he thought were in the neighborhood of 6 per cent rather consistently during the year, those were large errors.

While noting the fallibility of the projections, the Chairman continued, he would stress that the staff was engaged in pioneering research on the frontier of economic knowledge; the problem arose because that body of knowledge had not yet been developed to the point at which dependable projections could be made. How much use the Committee made of the projections was a matter for it to decide, but the fact remained that the errors were very large. In fairness, he should add that the projections for 1970 were a good deal better than those for 1971. Perhaps techniques would be developed in the future that would lead to consistently better results.

In reply to a question by Mr. Daane, the Chairman said the summary did not cover projections of reserves. However, he had asked the staff to make a more extensive study of projection errors, involving other key aggregates as well as M_1, covering a longer time period, and considering monthly as well as quarterly figures. The study would assess projections made at the New York Bank as well as those of the Board's staff.

Mr. Daane recalled when the Committee had last discussed reserve targets at its August meeting, the Manager had reported that the average week-to-week variations in total reserves had been somewhere in the area of $500 million during 1970, and that the average error in the New York Bank's weekly reserve projections had

been about $250 million. He asked whether the errors had been smaller in 1971.

Mr. Holmes replied in the negative.

Mr. Axilrod said he thought a distinction should be made between the magnitude of such errors under past operating procedures with a primary focus on money market conditions and those likely to result if the Committee were to decide that open market operations should be aimed specifically at attaining target levels for reserves. There would, of course, be misses because of the difficulty of anticipating the net impact of other factors on reserves, but the historical record did not lead to the conclusion that it would be impossible to attain the target levels with a reasonable degree of accuracy over a reasonable period of time. Under a reserve target the Federal funds rate would fluctuate more widely than in the past, but any problem on that score could be limited by a proviso constraining the range of fluctuation in the funds rate.

In reply to a question by Mr. Mitchell, Mr. Holmes said the Treasury's cash balances now totaled about $7-1/2 billion, which was well below the recent peak but still relatively high. The Treasury expected to be able to meet its requirements through mid-February by drawing on its balances. He thought that judgment was on the optimistic side, but if correct the Treasury should

have no problem until early March. In any case, the Treasury presumably would be drawing down its balances at the Reserve Banks during the weeks ahead, thus adding to the supply of reserves in a period in which the need was likely to be for reserve absorption.

Mr. Mitchell asked whether the Desk would be able to effectively neutralize reflows from abroad in the coming period, should they develop.

Mr. Holmes replied that it might well prove difficult to cope with a reflow of any significant size without supplying more reserves than desirable. Unfortunately, the Desk's earlier contingency planning against such reflows was not likely to prove helpful because, as he had indicated, the Desk would probably be absorbing seasonally redundant reserves after the coming statement week. Perhaps it would be possible to work out some combination of redemptions by the Treasury of special certificates issued to foreign monetary authorities and direct purchases of securities from foreign authorities by the Federal Reserve.

Mr. Mitchell then asked whether it would not be singularly inappropriate for the Treasury to undertake an advance refunding in connection with its February financing if there were substantial reflows from abroad at that time.

Mr. Holmes replied that reflows might complicate an advance refunding if they were sufficiently large and concentrated. However,

he would expect their major impact to be on the Treasury bill market, as a result of bill sales by foreign official accounts, rather than on financial markets as a whole.

Mr. Maisel asked whether there were indications currently of a shortage of Treasury bills in the market.

Mr. Holmes replied affirmatively. Yesterday, for example, when the Desk entered the market to buy $280 million of bills for foreign official accounts, it received offers totaling only $280.4 million--and at prices that were not especially attractive.

Mr. Maisel noted that dealer inventories of bills and notes had been relatively high as of a week ago. He asked whether dealers had drawn down their inventories since then, or whether they were holding onto the securities in anticipation of higher prices.

Mr. Holmes replied that dealer inventories were still relatively high. However, a large proportion of dealer holdings was tied up in repurchase agreements with corporations. Moreover, dealers were finding it possible to finance holdings at attractive rates, and with market interest rates declining they were not anxious to sell. At the moment dealers were in a state of euphoria as a result of the failure of the expected large reflows of funds from abroad to develop. That attitude could, of course, change quickly if foreign official accounts became large sellers of bills.

Mr. Francis asked whether the figures for reserves shown in the white book for January and February represented targets or projections.

Mr. Axilrod replied that the figures in question were targets in that they reflected the levels and growth rates for reserves which the staff believed would prove consistent with the indicated target paths for the monetary aggregates. However, they included a projection element in the sense they were premised on particular assumptions about the mix of deposits. Presumably the Committee would want to have the reserve targets adjusted if some other deposit mix emerged.

Mr. Mayo referred to the figures Mr. Axilrod had cited earlier regarding the actual growth rate in M_1 in the second, third, and fourth quarters of 1971 and the corresponding projections shown in the blue book and yielded by the econometric model. He noted that on average over the three quarters, the actual growth rate had been about 4.8 per cent, while the rates shown in the blue book and yielded by the model were 6.3 and 8 per cent, respectively, While he was aware of the fallacies of averaging, he wondered whether those results did not suggest that the staff had been giving too much weight to the econometric model.

Mr. Axilrod replied that he was not sure such a conclusion was warranted. He might note, for example, that the staff had

been prepared to include in the blue book a second-quarter projection as high as 7 per cent only because the model had suggested a 10 per cent growth rate. The actual growth rate then had proved to be a shade higher than 10 per cent.

Mr. Coldwell asked what explanation the staff would offer for the continuing sluggishness of M_1 despite the injections of reserves by the System.

Mr. Axilrod replied that, assuming nominal GNP expanded in the fourth quarter at about the rate the staff had estimated, the recent pattern of change in M_1 was about what might have been expected considering the typical lag between changes in interest rates and in the growth rate of the money supply. In short, the higher levels of interest rates prevailing before mid-August were still acting to hold down growth in money. Faster growth of money now seemed in prospect because the effects of the earlier high interest rates were beginning to wear off and those of the lower rates prevailing in the fall were beginning to appear.

Mr. Coldwell recalled that the Committee had been concerned about shortfalls in M_1 at about this time a year ago. He asked about the possibility that inadequacies in the seasonal adjustments had produced a misleading impression of shortfalls in both years.

Mr. Axilrod replied that there might be problems in connection with the seasonal adjustment factors for individual months--traceable, for example, to the effects on the money supply of the

recent changes in the regulations of the Office of Foreign Direct Investment. However, he doubted that such problems would result in an understatement of money growth over a period of two or three months.

Mr. Partee added that when the seasonal adjustment factors for the money supply series had last been revised in the fall of 1971 only minor modifications had been made and the averages of monthly factors for calendar quarters had been changed very little.

Mr. Brimmer asked Mr. Axilrod to comment on the likely outlook for interest rates if the Committee were to adopt either target I or II as outlined in the white book.

Mr. Axilrod replied that, as he had indicated earlier, the staff's judgmental projection indicated that in January and February M_1 would grow at annual rates of 6 and 10 per cent if prevailing money market conditions were maintained. If that projection were correct and the Committee adopted target II--calling for growth rates of 8 per cent in each of those months--interest rates should remain near current levels on the average, although they might fluctuate somewhat over the period. The econometric model, on the other hand, suggested that under unchanged money market conditions M_1 would grow at an average rate of 12.5 per cent in the first two months of the year. If the demand for money turned out to be as strong as implied by the model, growth

in M_1 at the target II rate would be associated with a firming of money market conditions and an upturn in market interest rates. If M_1 were to grow at the target I rate--6 per cent--both the judgmental and econometric projections would suggest that money market conditions would firm, perhaps sharply.

Chairman Burns asked Mr. Holmes about the New York Bank's projections of the monetary aggregates on the assumption of unchanged money market conditons.

Mr. Holmes replied that for the first quarter as a whole the New York Bank projected growth in M_1 at a rate of 8.5 per cent--in between the two Board projections, which were 7-1/2 and 10 per cent. The Bank's projection of M_1 for January was a little over 5 per cent and for February, 9 per cent. For M_2 and the bank credit proxy, the Bank was projecting first-quarter growth at rates of 10 and 8.5 per cent. There was a particularly large difference in the assessments of the outlook for the bank credit proxy in February; the Board's staff anticipated a substantial decline, whereas the New York Bank was projecting an increase.

Mr. Daane asked the Manager whether his operations in the period since the Committee's last meeting would have been substantially different if the Committee had formulated its target in terms of reserves.

Mr. Holmes said he would have difficulty in answering that question without an actual test. He also would need to know just how the reserve target was to be defined. For what it was worth, he might note that the actual growth in total reserves in the recent period had been relatively close to the path consistent with the Committee's policy decision at the December meeting.

In reply to a question by Chairman Burns, Mr. Holmes said that if his understanding of the reserve projections was correct the rise in seasonally adjusted total reserves in January would be very strong whether the Committee adopted alternative A or B for the directive, or if it called for no change in money market conditions. That assessment could, of course, be wrong; the errors in projections of reserves had been as large or larger than those in other aggregates.

Chairman Burns said he considered it so important to achieve adequate growth in reserves at this time that he would not want to depend on projections. He would prefer to have the Committee direct the Desk to supply the volume of reserves deemed appropriate. Such a course might well prove consistent with no change in money market conditions; but if not, he thought conditions should be permitted to change.

Mr. Hayes asked whether the Chairman would contemplate an instruction to permit money market conditions to change without limit.

Chairman Burns responded that in this matter, as in most matters, reasonable limits should apply.

In reply to a question, Mr. Axilrod said he agreed with Mr. Holmes that if money market conditions were unchanged seasonally adjusted total reserves were likely to rise substantially on average in January, particularly since their level thus far in the month was well above the December average. At the same time, he agreed with the Chairman that if the Committee wanted to assure such an outcome its best course would be to adopt a reserve target.

Mr. Mitchell remarked that if the Committee formulated its objectives in terms of a target for total reserves it presumably would want to attach some qualifications or provisos to its instructions. He asked Mr. Axilrod to comment on the types of provisos that should be considered.

Mr. Axilrod replied that one possibility, if the Committee was highly concerned about the short-run performance of the monetary aggregates, would be to call for modification of the target path for reserves if growth in, say, M_1 was deviating markedly from expectations. Another possibility, and one that was particularly important if the Committee wished to emphasize reserves available to support the money supply, was to provide for modification of the reserve target to take account of unexpected changes in Government

and interbank deposits, and possibly CD's, and also in demands for excess reserves.

Mr. Partee expressed the view that adjustments for unexpected changes in Government and interbank deposits would be essential, since such deposits were highly volatile.

Continuing, Mr. Axilrod observed that the staff also had suggested a proviso clause limiting the range of fluctuation in the Federal funds rate. Such a proviso would, among other things, provide protection against large errors in the assessment of day-to-day needs for reserves, since reserves would automatically be provided or absorbed by the Desk at the upper or lower points of the permissible range of fluctuation. As a result, the potential for destabilizing short-run interest rate gyrations would be limited. However, it would be important not to make the band of fluctuation too narrow, because that would simply lead to some of the same problems as a money market conditions target. The staff had suggested a band of three percentage points.

Mr. Holmes noted that the discussion of reserve targets had been proceeding in terms of seasonally adjusted figures. Unfortunately, the Desk had to operate in a seasonally unadjusted world, and he questioned whether procedures had been worked out in sufficient detail at this point to meet the needs of day-to-day operations. He was particularly uneasy about the risk that wide swings in the

Federal funds rate would be created by System operations that reflected faulty seasonal adjustments or erroneous projections.

Mr. Daane remarked that there was one statistic which he would consider to be of particular importance from the point of view of the Chairman's testimony before the Joint Economic Committee--namely, the figure for the annual rate of growth of total reserves from the statement week including August 15, when the new economic program was announced, through the latest statement week for which data were available.

Mr. Axilrod said he did not have that figure at hand but would provide it later in the meeting.

Mr. Mitchell asked whether recent developments with respect to total reserves could not be fairly summarized by noting that, while the figures were highly erratic in the short run, reserves had grown at an annual rate of about 7 per cent over the year 1971.

Chairman Burns replied that such a summary was not likely to be considered sufficient by many observers, including some members of Congress. He would expect attention to focus on the more recent developments, including the net decline in total reserves and the very low growth rate in the narrow money supply during the fourth quarter.

Mr. Maisel remarked that the Committee's target growth rate for M_1 since the mid-October meeting could be said to have been

1.1 per cent, in the sense that that figure was obtained when one averaged, for the final three meetings of the year, the growth rates over the four weeks following the meetings that were consistent with the policy decisions taken by the Committee. Since the actual growth in M_1 over that period was now estimated at 0.8 per cent, it could be said that the Committee's target had been virtually achieved.

Chairman Burns observed that he was puzzled by Mr. Maisel's comment. It was his impression that the Committee had sought growth in M_1 over that period at a rate of about 6 per cent.

Mr. Maisel said he thought a review of the record would indicate that it was not until the November meeting that the Committee had become highly concerned about the sluggishness in M_1. Moreover, while members may have expressed a preference during the three-month period for longer-run growth in M_1 at about a 6 per cent rate, at each meeting the Committee set specific constraints on the degree to which the Manager was authorized to reduce the Federal funds rate, and the minimum funds rates approved tended to be associated in the blue book with relatively low growth rates in M_1.

Mr. Hayes observed that according to his recollection the Committee had concluded at its meetings in late summer and early autumn that a low growth rate in M_1 would be quite appropriate

for the time being in light of its very rapid expansion through the first seven months of the year.

Chairman Burns remarked that as the members would recall the Committee had been disappointed by the shortfall in the monetary aggregates that had occurred in the fourth quarter of 1970, and had sought to rectify the situation in the early months of 1971. Over the six-month period including the fourth quarter of 1970 and the first quarter of 1971, the average rate of growth of M_1 was a little more than 6 per cent--approximately equal to the target the Committee had set. In the second quarter of 1971 there had been a monetary explosion which was disturbing to all of the members. It had proved possible to substantially offset that development in the third quarter, and the average growth rate for the second and third quarters together was 7 per cent--again approximately on target.

It was the virtual absence of growth in M_1 in the fourth quarter that he thought was difficult to justify, the Chairman continued. He believed, and was fully prepared to argue, that no damage had been done to the economy as yet in view of the liquidity the Federal Reserve had supplied earlier. However, unless the aggregates now began to grow at adequate rates he would become fearful about the future of the economy, and he would also feel that there might be some validity in a charge that the System was not supporting the policies of the Administration and Congress.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period December 14, 1971, through January 10, 1972, were approved, ratified, and confirmed.

At this point the meeting recessed for lunch and reconvened at 2:30 p.m. with the same attendance as at the morning session.

Mr. Axilrod said he was prepared to answer the question which Mr. Daane had asked before the luncheon recess about the growth rate of total reserves since the new economic program was announced. From the statement week ending August 18, 1971, through the week ending January 5, 1972, total reserves increased at an annual rate of 8.8 per cent. Approximately the same growth rate would be obtained if the base were moved forward two weeks to the week ending September 1. However, if the intervening week, ending August 25, were used as the base, the growth rate would be found to be 12.4 per cent. Using average figures for calendar months, from August through December the annual rate of growth in total reserves was 3.3 per cent.

Chairman Burns then said he would like to make a brief comment on interest rates before the Committee began its go-around on monetary policy and the directive. He thought the Committee might have been a little timid recently in its willingness to accept interest rate fluctuations; he knew he had been. Since there

could be a further reduction in interest rates, possibly of significant dimensions, if the Committee concurred in his view that a substantial addition to reserves was required in the weeks immediately ahead, it might be helpful if he were to provide some historical background. Specifically, he proposed to review the levels of the three-month Treasury bill rate during successive periods since World War II in which the unemployment rate had been in the neighborhood of 6 per cent, as it was throughout 1971.

The first such period, the Chairman observed, was from May 1949 to April 1950. During that period the 90-day bill rate averaged 1.1 per cent. The unemployment rate was again approximately 6 per cent between April and September 1954, when the bill rate averaged 0.8 per cent. From January 1958 to February 1959 the unemployment rate was a little more than 6 per cent, and the average bill rate was 1.9 per cent. From October 1960 to January 1962 the unemployment rate was again about 6 per cent, and the bill rate was approximately 2-3/8 per cent on the average.

In the present instance, the Chairman continued, the unemployment rate had been in the neighborhood of 6 per cent since November 1970. From then through December 1971 the average three-month Treasury bill rate was about 4-1/2 per cent. People had grown accustomed to rather high interest rates, which had been brought on in large part by inflation and inflationary expectations. Hopefully--

although not certainly--inflation was now in process of coming under control. In his view, if the Committee was to attain its objectives it must now be prepared to accept larger fluctuations in interest rates than it had been willing to countenance until now. The Committee's past attitude toward interest rates was understandable and, as he had indicated, his own thinking had been in sympathy with that of the other members.

The Chairman then asked whether the Manager had any advice to give the Committee on monetary policy, in light of the discussion earlier today.

Mr. Holmes observed that one of the major thrusts of the discussion thus far concerned the desirability of rapid growth of total reserves in January. It had been suggested earlier that seasonally adjusted reserves might increase this month at the 26 per cent annual rate discussed in the white book if current money market conditions were maintained. However, as had also been noted, one could not be sure of such a projection. If the Committee decided that that growth rate should be sought--subject, perhaps, to some constraints--it need only so indicate, and the Desk would do its best to achieve it.

Mr. Brimmer said he thought it was important--for the sake of facilitating a later assessment of the extent to which the Desk's operations conformed to whatever instructions the Committee issued today--to know whether operations would be different if an instruction

of the kind Mr. Holmes had mentioned was associated with a directive along the lines of alternative A rather than B.

In reply, Mr. Holmes noted that the white book suggested alternative B for consideration if the Committee decided to emphasize bank reserves as the operating target, and alternative A if it preferred a money market emphasis. However, as he read the language of alternative A, it could also be interpreted in a manner consistent with primary stress on reserves. Thus, the key question for operations concerned the Committee's interpretation rather than the directive itself.

Mr. Maisel remarked that the format of the white book called for decisions by the Committee on two separate questions, involving the choice of targets for operations as well as the choice of operating procedures.

Mr. Mayo said he had some questions about the draft the staff had submitted for the first paragraph of the directive which might be disposed of at this point. First, he thought the final clause of the sentence concerning wage and price developments contributed little and should be deleted. That clause read "...among proposed increases submitted to the Pay Board and Price Commission some have been approved but others have been cut back or not approved."

There was general agreement that the clause should be deleted.

Secondly, Mr. Mayo continued, in connection with recent international financial developments the draft stated that "...there has been a moderate volume of capital reflows to the United States." He wondered whether the word "moderate" did not imply larger reflows than had in fact occurred.

After discussion, the Committee decided that the word "moderate" should be replaced by "modest."

Mr. Brimmer noted that the draft of the first paragraph did not include any summary statement regarding recent developments in the country's balance of payments.

Chairman Burns asked the staff to draft such a statement for consideration by the Committee at a later point. The Chairman then called for the go-around of comments on monetary policy and the directive. He suggested that the members postpone any comments they might have on the question of appropriate discount rate levels for the time being, since it would be convenient to combine the discussion of that subject with the discussion of discount rate-setting procedures planned for the joint meeting of the Board and Reserve Bank Presidents which would follow the meeting of the Committee. Also, he hoped the members would keep in mind Mr. Maisel's observation that the Committee had to make decisions today with respect to both targets for operations and operating procedures.

The go-around then began with the following statement by Mr. Hayes:

In deciding on policy today, I think we should keep in mind that we have been pressing pretty hard in the direction of greater ease, to the extent that "ease" can be defined in terms of money market conditions. In two months the Federal funds rate has dropped from around 5-1/4 per cent to well below 4 per cent, and other short-term rates have declined almost as much. Concern for the growth of M_1 has been a valid reason for moving in this general direction, but let's not overdo it, having in mind the satisfactory growth of M_1 for the year as a whole, the generous recent growth of M_2 and the credit proxy, the vast improvement in personal and corporate liquidity, and the signs of slightly greater strength in the economy. I sympathize with those members of the Committee who have warned against excessive focusing on the narrow money supply as the be-all and end-all of policy. Of course the money supply is important, but so are the other aggregates, and so are credit conditions and general measures of liquidity. Even M_1 gives considerable promise of accelerating in January and succeeding months.

We should guard against whipsawing the financial markets unnecessarily in the midst of a Treasury financing operation, which might well be the result if we press further for lower interest rates, only to have to tighten rather suddenly if the aggregates begin to get away from us on the up side, as they did last spring, and as the white book suggests they might do again. We should bear in mind too that the lower market rates go in this country, the less rate incentive there will be for massive dollar reflows that could help restore a stable international atmosphere. I see no need for apologizing for the System's recent stance as not offering enough support to economic expansion, especially when fiscal policy is as stimulative as it is. And the view that no apologies are needed for recent System policy is supported, I believe, by the figures on reserve growth since the middle weeks of August which Mr. Axilrod has supplied in response to Mr. Daane's question of this morning.

I would advocate a policy of maintaining money market conditions about where they are, with Federal funds in the 3-1/2 to 4 per cent range, and with modest free reserves and only fractional borrowing. If in the coming weeks M_1 seems to be growing at less than a 5 per cent annual rate, then some easing of money market

conditions, with a Federal funds rate of about 3-1/4 per cent, would seem appropriate.

Neither of the staff's draft directives appeals to me. Alternative A and the associated specifications call for immediate easing of money conditions without waiting to see if the aggregates are moving back to target. As to a switch to a reserve target, proposed in connection with alternative B, I feel that the Committee needs more detailed information about what is involved in so major a step before a sensible judgment can be made. I am distinctly uneasy about a plunge into a policy entailing swings in the funds rate in a range as wide as 2 to 5 per cent. I would propose the following language, which might be labeled alternative C, for the Committee's consideration:

> To implement this policy, taking account of the forthcoming Treasury refunding, open market operations shall be conducted with a view to maintaining prevailing money market and bank reserve conditions, but somewhat easier conditions should be sought if the Committee's desires with respect to the growth of money and credit aggregates are not being achieved.

In response to a question by Chairman Burns, Mr. Hayes said that for January and February he would be content with either a 6 or an 8 per cent rate of growth in M_1--the alternative targets labeled I and II, respectively, in the white book--provided that such rates developed under prevailing money market conditions. Of the two, however, he preferred the target I growth rate. As he had indicated, he would ease money market conditions further only if M_1 appeared to be growing at a rate below 5 per cent.

Mr. Morris noted that he was a member of the committee on the directive which for some time had been urging the Open Market Committee to shift to a reserve target for implemention of policy

and to accept broader swings in the funds rate as a necessary consequence. Today, however, he favored adoption of alternative A. A shift to a reserve target, as the directive committee had made clear in its first report two years ago, would constitute a fundamental change in operating procédures; and one of the conditions necessary for its success was that the market be informed of the change and understand its implications. Some instability in the market was to be expected during the period in which both the Committee and market participants adjusted to the new system. While he was convinced that the adjustment would be quite rapid, it would still require a little time.

Chairman Burns expressed the view that the decision to be reached today should be concerned only with operations over the period until the next meeting, rather than for the indefinite future. There should be no prejudgment of or prejudice to the question of whether the Open Market Committee should approve the recommendations to be contained in the forthcoming report of the directive committee.

Mr. Morris said his concern was that an effort to implement so radical a change in operating techniques without notice to the market, and just two weeks before the Treasury's February refunding, would in fact prejudice the future of the operating procedures which he considered appropriate for the longer run. He agreed, however,

that it was necessary to assure adequate expansion in reserves over coming weeks, and would so instruct the Manager. He favored target II.

Mr. Coldwell observed that in determining policy today the Committee had to face several issues. The first was whether a faster rate of reserve creation would be desirable when financial institutions already were awash with liquidity and prospects for economic growth were favorable. The second was whether the Committee should be greatly concerned about the slow growth in M_1 when M_2 and the credit proxy were growing rapidly. The third was whether the Committee's recent aggressively easy policy could actually improve the unemployment situation or, without serious risks, could force growth in M_1. Finally, the Committee should consider whether stimulating the economy to greater heights in the short run would not involve a cost in the form of a resurgence of inflationary pressures later on.

Personally, Mr. Coldwell said, he would favor proceeding cautiously in further emphasis on credit creation. He did not care for either alternative A or B of the draft directives. Like Mr. Morris, he thought adoption of the alternative B approach at this time might prejudice a later shift to reserve targets. The language proposed by Mr. Hayes had some attraction, but he would

prefer a directive which made clear that account was to be taken of M_2, the credit proxy, and total reserves as well as of M_1 in the conduct of operations. With respect to targets, he would be satisfied with target I, involving M_1 growth at a rate of 6 per cent in January and February. The associated M_2 growth rates of 9-1/2 and 6-1/2 per cent might seem to be on the high side, but he thought they were consistent with the needs of the economy. However, he considered the target II monetary growth rates to be too high. In any case, it was not yet clear how much monetary growth would be produced by the recent easing of money market conditions, and he hoped the System would not embark on a program of rapid expansion of reserves at this point.

Mr. Swan remarked that while he would like to see M_1 expand a little faster, he was not as concerned about its recent sluggish behavior as he would have been if M_2 and the credit proxy had not been growing more rapidly than anticipated. There was a great deal of liquidity in the banking system and in the economy generally, and he thought the Federal Reserve was already meeting the objective Mr. Partee had suggested it adopt--namely, a "free flow of credit, at gradually declining interest rates." Consequently, he preferred target I. Also, he favored the alternative B approach to operations, partly because greater stress on reserves would tend to reduce the focus on the narrowly defined money supply. In his judgment, the Committee had continued to concentrate too

closely on M_1 despite repeated statements by members that it was not desirable to do so. While he appreciated Mr. Morris' reservations regarding a shift to reserve targets at this time, he did not believe that markets would be disrupted or many questions raised if the Committee combined alternative B with target I, the lower of the two targets.

Mr. MacLaury referred to the Chairman's earlier comments about the growth rates of the money supply over the past year, and to the view the Chairman had expressed that the System's policies had done no damage to the economy thus far. He (Mr. MacLaury) fully shared that view; indeed, he thought a more positive statement was warranted, to the effect that the System could take credit for its contribution to the recent and prospective expansion of the economy at what he would consider to be a satisfactory pace.

Mr. MacLaury went on to say that he was disturbed by the tendency in the discussion of policy today to focus on January and February and not consider the consequences that policy actions taken now would have for later months. He agreed that errors in the projections of the monetary aggregates had created difficulties in the past. To his mind, however, that did not justify ignoring the lags in the responses of the aggregates to changes in money market and reserve conditions. He was particularly disturbed by the idea that the Committee should seek to achieve some specified rate of growth in reserves over the short run

without regard to the consequences thereafter. If one could place any confidence at all in the staff's projections, it would appear that the monetary aggregates were likely to grow at satisfactory rates over the next few months as a result of the easing of money market conditions that had already occurred.

In short, Mr. MacLaury continued, he would be reluctant to shift to a reserve target at this time without full consideration of the longer-run implications of such a step. He favored Mr. Hayes' alternative C for the directive, and he had no strong preference between I and II as targets for operations. He was not bothered at all by the prospect of wider swings in money market rates, and he believed that the Committee should be prepared to accept such swings in its effort to achieve appropriate growth rates in the aggregates. However, he would not want to press for lower short-term interest rates now, since he thought it would be necessary to reverse course in the near future to keep the monetary aggregates from growing at excessive rates.

Mr. Mayo said he was attracted to the principle of reserve targets involved in alternative B, partly because he considered it desirable to reduce the emphasis on M_1. He thought the shift could be made at this time if appropriate limits were set on the range of fluctuations in the Federal funds rate. Instead of the range of 2 to 5 per cent proposed by the staff he would favor a

range of 3 to 4 per cent, both because some weight would have to be given to even keel considerations in connection with the Treasury's February refunding and because it would seem desirable to avoid wide fluctuations in the funds rate in the first month of the new approach to operations. If the Committee limited itself initially to placing a little more emphasis on providing "the bank reserves needed to support greater growth in the monetary aggregates" it should be able to start down the new path without upsetting the market. As to the objectives of operations, he preferred target I. With January already one-third over, he believed the target II growth rates for that month were no longer realistic.

Whether alternative A or B was adopted for the second paragraph of the directive, Mr. Mayo continued, he would favor making two changes in the staff's draft language. First, as Messrs. Brimmer and Daane had suggested earlier, he would restore the clause calling for account to be taken of international develpments. Secondly, he would substitute "substantial" for "greater" in describing the kind of growth in the aggregates sought by the Committee, on the grounds that both M_2 and the bank credit proxy had been growing at acceptable rates.

Mr. Clay noted that the Committee had had some problems in recent months in attaining the desired growth rates in the monetary aggregates. It should be recognized, however, that that shortfall had involved primarily M_1 rather than the aggregates generally. The policy alternatives presented by the staff today, with their supporting specifications, constituted a very concentrated effort to increase the growth rates of the monetary aggregates, and specifically the M_1 rate. In undertaking that approach there was a risk of setting in motion forces leading to excessively high growth rates later. That risk was accentuated by the emphasis on M_1 as the yardstick, as the Committee could not control the linkages between growth in bank reserves and M_1, nor could it control subsequent shifts between other deposit components and the M_1 components.

Accordingly, Mr. Clay said, adoption of a policy such as was suggested for consideration today should include a firm resolve to reverse policy with respect to both the aggregates and money market rates when that became appropriate to avoid going too far on the expansive side. Even so, there was no assurance of successfully reversing policy with appropriate timing.

The more satisfactory approach at this time, Mr. Clay concluded, seemed to be represented by alternative A of the draft directives with target I as set forth in the white book.

Mr. Heflin remarked that he was satisfied that the Committee had to take some action to increase the growth rate of the aggregates in the short run. However, he also considered it important that the Committee not do more than was necessary, and particularly that it not do a great deal more than was necessary. In deciding on policy today the Committee should keep in mind the fact that the System had eased the money market to no inconsiderable extent over the past few weeks.

Mr. Heflin noted that the directive the Committee had adopted at its last meeting referred to the bank reserve as well as the money market conditions to be sought. It was his impression, however, that in the course of operations much more weight had been put on money market conditions than on reserves. In view of the difficulties that had been experienced in the past with money market conditions as the operating target, he had great sympathy for the proposal to use reserves instead. In his judgment, however, the eve of a Treasury financing was not the time to make the change. It seemed to him that alternative A of today's draft directives, which was similar to the December directive, would be appropriate for the coming period, but he would want to place increased emphasis on the behavior of reserves. Thus, the Manager could be instructed to aim at a Federal funds rate within a range of 3-1/2 to 3-5/8 per

per cent, on the understanding that he would move the funds rate down another 25 or 50 basis points if necessary to accommodate the growth in reserves required for faster monetary expansion.

Mr. Mitchell said he could recall the time when Committee members felt they could describe their policy preference simply by choosing from among the terms "tighter," "easier," and "unchanged." On that basis, he would place himself in the "easier" --or perhaps "somewhat easier"-- category today, because he thought the economic situation pointed in that direction. While he was not unmindful of the considerations that Mr. Morris had cited this morning, he saw no harm in probing toward ease.

Mr. Mitchell commented that he had difficulty in expressing a preference for the directive since each of the alternatives under consideration could be interpreted in a number of different ways. On balance, however, he favored alternative B, for the reasons Mr. Mayo had advanced. He had been disappointed by the results of the Committee's efforts to use M_1 as a target variable, and contrary to positions he had taken in the past he would prefer to use total reserves for that purpose now. In considering what growth rate should be sought, he had examined the monthly rates of change in reserves over the past fifteen months. The figures ranged from plus 18 to minus 16 per cent, and the median growth rate was about 8-1/2 per cent. Against that background, he would

consider a growth rate of 8 per cent to be a creditable performance now, and he would not want the rate to be below 6 or above 18 per cent. He was not sure what range should be specified for the Federal funds rate in order to achieve acceptable growth in reserves, but he suspected that the range would have to be greater than plus or minus 50 basis points.

Mr. Daane said he thought it was unfortunate that the present committee on the directive had begun its historical investigations with the 1964 report of a predecessor committee consisting of Messrs. Mitchell, Swan, and Ellis. Had they gone back to the record for the mid-1950's, they would have discovered that the group of Associate Economists to the Federal Open Market Committee, which had included himself, had prepared reports in which each of the various possible guides to policy--including total, nonborrowed, and free reserves, and interest rates--had been given extensive consideration. In the course of that study, various pitfalls in the use of reserves as operating targets had been uncovered.

Today, Mr. Daane continued, he certainly would not want to employ the alternative B approach, particularly since the Manager could be instructed to give appropriate weight to total reserves within the purview of alternative A. He agreed with Mr. Morris and others who thought that this was a poor time to make a fundamental change in operating procedures. But beyond

that, a change of the kind under consideration should not be made without extensive discussion by the Committee.

While he favored alternative A for the directive, Mr. Daane said, he would amend the staff's draft language to restore not only the reference to international developments but also the phrase "over the months ahead" following "greater growth in monetary aggregates." Personally, he thought the behavior of total reserves since the adoption of the new economic program was somewhat more defensible than did Chairman Burns; according to the figures Mr. Axilrod had supplied, total reserves had grown at an annual rate of 8 to 12 per cent since mid-August, depending upon the particular week used as the base. It was true, however, that in terms of the less volatile monthly statistics, growth in total reserves since August had been at a rate of only 3.3 per cent. Hopefully, faster growth could be achieved. He did not like Mr. Hayes' alternative C language because it called for no change in "bank reserve" conditions. He would favor interpreting the alternative A language to call simply for erring on the side of ease with a view to achieving satisfactory performance of total reserves. He would not want to name any precise target, but he would be quite satisfied with a January growth at a rate of 20 per cent, or at the 26 per cent rate discussed in the white book.

Mr. Daane added that such a prescription might or might not be consistent with no change in money market conditions. In any case, he hoped the Committee would not again lock the Manager into some narrow range for the Federal funds rate, as it had in December. If the Manager was to be held accountable for improving the performance of reserves, he had to be given the latitude necessary to the task. At the same time, he (Mr. Daane) would not want to see a quantum change in money market conditions on the eve of a Treasury refunding.

Mr. Maisel expressed the view that the staff's projected growth rate in nominal GNP of 10 per cent for the year ending in the fourth quarter of 1972 was a logical goal, and one that should be supported by monetary policy. From the record for recent years, he would conclude that to achieve such an expansion in GNP M_1 and M_2 should grow at rates of about 8 and 10 per cent, respectively. Those growth rates were consistent with the rates shown for January and February under target II in the white book.

As he had noted earlier, Mr. Maisel said, the Committee had to decide not only on its targets but also on the operating procedures that should be employed in reaching them. He favored the procedures outlined under alternative B. While he preferred a nonborrowed reserves target, he would be willing to have total reserves employed for the purpose at this time. However, he thought the

Committee's targets should be formulated in terms of such periods as a year or a half-year. A quarter might also be an acceptable period; however, in view of the instability of growth rates in the short run, it might not be long enough. In any case, he thought a month or six weeks was far too short a period for a target for the monetary variables.

Mr. Maisel remarked that the Committee had had considerable experience with the difficulties of achieving targets for the monetary aggregates by specifying operating instructions in terms of the Federal funds rate. The problem of deciding what funds rate would be appropriate appeared to be especially difficult at this time. Thus, the white book indicated in its discussion of alternative A that, to achieve either the target I or II objectives for M_1, the funds rate might have to be reduced to 3 per cent in the two weeks before the Treasury refunding announcement, whereas the econometric model apparently indicated that the funds rate should be rising rather than falling over coming weeks.

However, Mr. Maisel observed, partly for the reasons Mr. Morris and others had expressed he would favor setting outer limits for the range of fluctuation in the funds rate--say, from 2-1/2 to 4-1/2 per cent--on the understanding that the limits would apply not to the rate on individual days but to weekly averages calculated with leeway to exclude extreme figures. He felt that on

occasion the Desk had worked too hard to resist declines in the funds rate on the last day of the statement week; he would not be concerned if the rate fell to zero for a day.

Mr. Brimmer said he thought the approach to policy-making being followed in today's meeting represented retrogression. In recent years the Committee had improved its procedures by lengthening the time horizon over which it considered policy and by taking account of the lags in the effects of policy on economic activity, but much of that progress was being sacrificed today. He was troubled also by a confusion between the Committee's task of policy-making and the staff's task of technical analysis; it seemed to him that the Committee was getting bogged down in technical details.

While he found it difficult to discuss appropriate monetary policy for a period as short as six weeks, Mr. Brimmer remarked, he was obliged to express a judgment. First, he would note that he did not favor employing total reserves as an operating target. Since the committee on the directive would be submitting a report soon--and since that group was expected to recommend the use of some measure of reserves as an operating target--it seemed best to await the committee's report before shifting to a reserve target. He would much prefer to have the Desk operate within the framework of alternative A. With respect to objectives for the period through the end of February, he thought the Manager should try to achieve

somewhat more expansion in bank reserves. How much more seemed to him to be largely a matter of guesswork--given the wide variation in recent growth rates that Mr. Mitchell had cited--and he would not want to name any specific figure. In any case, the Manager should have a substantial amount of leeway with regard to the Federal funds rate in the coming period.

For the longer run, Mr. Brimmer continued, he had no particular preference between growth rates of 6 or 8 per cent for M_1. In general, he thought the Committee had been placing too much emphasis on M_1 recently, and he hoped it would not decide to go to great lengths to achieve some particular rate of growth for that variable. Personally, he had been impressed by the recent behavior of M_2 and the bank credit proxy.

With respect to the directive, Mr. Brimmer said he favored alternative A. However, he would retain the clause "while taking account of international developments" because of the possibility of enlarged reflows in coming weeks. He also would retain the words "over the months ahead" to suggest the kind of policy horizon he considered appropriate.

Mr. Sheehan noted that, according to the staff projections, there would still be a high rate of unemployment and a low rate of capacity utilization in the fourth quarter of 1972, after two years of economic expansion. In light of that prospect he favored an

expansive policy. He would like to see M_1 grow at the 8 per cent rate of target II, and he preferred the alternative B approach to operations.

Mr. Sheehan said he gathered from some of the earlier discussion that there were times when the Manager was uncertain about the precise interpretation he should place on the Committee's instructions. If that impression was correct it would be desirable for the Manager to review his understanding of the instructions with the Committee before the conclusion of the meeting.

The Chairman responded that, while there might be room for improving procedures, the Committee's instructions ordinarily were spelled out with a reasonable degree of precision before the meeting adjourned. In addition, there were opportunities afterward to clear up any remaining uncertainties.

Mr. MacDonald said he thought the economy needed greater monetary stimulation at this time, and he would regard the target I growth rates for the aggregates as minimums. He was sympathetic toward the ultimate use of total reserves as the operating target, but in view of the technical problems mentioned by Messrs. Morris and Heflin, he leaned toward alternative A today.

Mr. Willes remarked that there was no great concern at the Philadelphia Reserve Bank about the recent lack of growth in M_1 in light of the behavior of the other aggregates. However, there

also would not be much concern if M_1 began to grow rapidly in the near future, so long as such growth did not persist for long. He had a fairly strong preference at this time for target I.

With respect to operating procedures, Mr. Willes observed that the Philadelphia Bank had long been in sympathy with the proposal of the directive committee for the use of reserves as the target of operations. Accordingly, he favored the adoption of alternative B today. That course struck him as especially desirable in light of the current uncertainties about the relationships between the aggregates and interest rates. In his view, the Committee would find it easier to achieve its objectives by casting the directive in terms of reserves rather than money market conditions.

Mr. Kimbrel said he hoped that whatever action the Committee took today would be designed to contribute to the attainment of the basic aims of the new economic program. In evaluating how the Committee might best contribute to those goals, he was influenced by developments in his own District, where he detected a pattern of strengthening activity and improving business confidence.

In his judgment, Mr. Kimbrel continued, an orderly reduction of interest rates over an extended period of time in response to market forces should be encouraged by System policy. He was fearful,

however, that a sharp immediate reduction, contrary to market forces, would be a disservice to orderly, long-run economic expansion and the control of inflation. From his contacts with businessmen and bankers, he could not avoid concluding that immediate further moves to push rates down would be interpreted in such a way as to reduce confidence and to increase inflationary expectations. Despite the many present uncertainties, the weight of evidence seemed to point to the possibility that lower rates would be unsustainable. A sharp decline in rates followed by a sharp rise would be disturbing.

A greater fear, Mr. Kimbrel observed, was that the System could be getting into a situation similar to that of early 1971. The 1971 experience suggested that a "catching-up" policy with respect to the monetary aggregates could be dangerous. It seemed to him that the Committee should take precautions that would avoid a possible repetition of last year's experience. To him, that implied keeping policy about where it was right now.

Translating the foregoing into operating instructions, Mr. Kimbrel remarked, he would not like to see an immediate sharp increase in money market rates, although he would not be averse to a slight firming associated with market forces. Nor did he believe that further aggressive action to force down rates was appropriate at this time. He would consider a Federal funds rate between 3 and 4 per cent to be appropriate. If a funds rate in

that range were accompanied by growth in M_1 at a rate of around 6 or 8 per cent, he would be gratified; but if it were not, he would hope the Desk would not aggressively push the funds rate down below the lower end of the range.

Neither of the staff's two directive alternatives would quite achieve what he believed would be appropriate at this time, Mr. Kimbrel said. He was sympathetic to the use of long-run growth rates in the monetary aggregates as long-run policy guides. However, an emphasis on the short-run change in M_1 as a sole guide, as proposed in the white book in connection with alternative A, seemed dangerous to him. This might be the time to emphasize money market conditions. For much the same reasons, he would not favor alternative B.

Mr. Kimbrel said he would prefer alternative A, but with the words "over the months ahead" restored to indicate that it was the long-run growth rate of M_1 that was of concern; and with the Desk instructed to avoid pushing the Federal funds rate below 3 or above 4 per cent. Also, he would prefer to see M_1 grow at a 6 per cent rate, as suggested by target I.

Mr. Francis remarked that, as had already been noted, the System had not achieved targeted growth rates in the money stock since last August despite an obvious desire to take appropriate actions to assure desired monetary expansion. Today, he wished

to emphasize three major points. First, he very much desired a resumption of money growth, but he was opposed to a sudden and rapid expansion of the money stock in an attempt to offset the lack of growth since August. Second, an approach which employed marginal changes in money market conditions had not in the past provided desired monetary growth and was unlikely to do so now. Third, he endorsed the change in the Committee's operating procedures presented under alternative B because he believed it would increase the probability of achieving a desired rate of money growth.

Mr. Francis observed that the Committee's recent failure to achieve a desired rate of monetary expansion by manipulating selected measures of money market conditions, along with several similar instances during the past few years, led to but one conclusion. Given the present uncertainties about the interrelationships among open market transactions, money market interest rates, and monetary expansion, such procedures should be abandoned for a more direct approach to controlling monetary growth. That was particularly important at this time. Money market interest rates had fallen considerably and were at comparatively low levels, but he questioned whether the Committee could accept the risk that continued negligible growth in money would lead to an economic slowdown.

In his judgment, Mr. Francis continued, adequate monetary control would not be as difficult to achieve as some had implied if the Committee would change its operating procedures--as suggested in connection with alternative B--to place the main emphasis on a monetary aggregate which could be closely controlled by the Desk. He thought the proviso clause of alternative B, relating to the range of fluctuations in money market conditions, should be interpreted as broadly as suggested in the white book. Any narrowing of the indicated range for the Federal funds rate--2 to 5 per cent--would tend to lead the Committee back to the procedures of late last year. He preferred the target I paths for the monetary aggregates.

Mr. Robertson expressed the view that conditions were not in as bad a shape as some of the discussion around the table today suggested. The economy was expanding, and with the exception of M_1 and total reserves the monetary and credit aggregates had been increasing. Nevertheless, in view of the continuing high rate of unemployment, he agreed that monetary policy should seek to contribute to economic expansion. At the same time, it should be recognized that the battle against inflation was not yet over, and that unduly aggressive policy actions would involve the risk of rekindling inflationary expectations.

Mr. Robertson said he favored shifting to a reserve target, and accordingly he preferred alternative B for the directive. He

thought M_1 should be downgraded for target purposes because, unlike reserves, it was not subject to close control by the System.

At present, Mr. Robertson continued, he believed the objective should be to achieve a modest increase in reserves in order to get somewhat more growth in the monetary aggregates. With that thought in mind, he would amend the language of alternative B to call for supplying the "additional" bank reserves needed to support "somewhat" greater growth in monetary aggregates. Also, he agreed that the reference to international developments should be restored. As to targets, if he had to choose between I and II, he would take I; but since he was not confident that either of the specific sets of growth rates listed could be achieved, he would prefer not to name either.

Chairman Burns remarked that the Committee had had a very thorough discussion. He would first summarize the preferences expressed with respect to targets and the language of the directive, and then he would make a proposal on which the Committee might vote.

With respect to targets, the Chairman observed that the members of the Committee who had expressed a preference were about evenly divided between targets I and II, typified respectively by 6 and 8 per cent growth rates for M_1 in January and February. If the preferences of Reserve Bank Presidents who were not now members of the Committee were included, a majority favored the lower target.

With respect to the language of the second paragraph of the directive--and counting his own preference--six members favored alternative B, under which reserves would be used as the target for day-to-day operations; five favored A; and one--Mr. Hayes--favored C. If asked to choose between alternatives A and B, Mr. Hayes no doubt would favor A, leaving the Committee evenly divided. If the views of the nonmember Presidents were included, a majority preferred B.

To resolve the issue, Chairman Burns continued, the Committee might vote on a proposal involving adoption of an amended version of alternative A, subject to a specific interpretation. The directive language he had in mind was as follows: "To implement this policy, while taking account of international developments and the forthcoming Treasury financing, the Committee seeks to promote the degree of ease in bank reserve and money market conditions essential to greater growth in monetary aggregates over the months ahead." He proposed that the Desk be instructed to interpret that language as calling for allowing the spirit of alternative B to prevail by placing emphasis on supplying reserves to a satisfactory degree. Specifically, against the background of the staff projection for very sizable growth in total reserves in January, the Desk would be instructed to aim for an annual rate of growth in total reserves from December to January in a range of

20 to 25 per cent, lowering the Federal funds rate to 3 per cent if necessary to attain that objective. Should the Manager find that reserves nevertheless were not growing as desired, he was promptly to inform the Chairman, who would then decide whether it was desirable to call an interim meeting of the Committee, perhaps on January 18 or January 25.

Mr. Holmes asked whether the Desk would be expected to maintain prevailing money market conditions if staff estimates at the Board and the New York Bank indicated that the growth rate of total reserves in January was within the desired range, and Chairman Burns replied affirmatively.

Mr. Holland noted that the Committee had agreed earlier on certain revisions in the staff's draft of the first paragraph of the directive. Also, it had asked the staff to develop a statement regarding recent developments in the balance of payments for possible inclusion in that paragraph. The staff suggested the following revision in the directive language at that point: "...market exchange rates for major foreign currencies against the dollar initially moved to levels a little above their new lower limits. The volume of capital reflows to the United States has been modest, however, and the underlying U.S. balance of payments remains in deficit."

The Committee agreed that the revised language was preferable to that in the staff's original draft.

The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft of the first paragraph with the revisions decided upon, and the revised version of alternative A for the second paragraph with the understanding that the second paragraph would be interpreted in the manner he had outlined.

Messrs. Hayes, Brimmer, and Kimbrel indicated that they planned to dissent from the proposed directive. It was understood that the dissenting members might submit statements setting forth the reasons for their negative votes for inclusion in the record.

> With Messrs. Hayes, Brimmer, and Kimbrel dissenting, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting suggests that real output of goods and services increased more rapidly in the fourth quarter than it had in the third quarter, but the unemployment rate remained high. In recent weeks wage and price developments have reflected some increases that had been deferred under the 90-day freeze. The narrowly defined money stock, which had not grown on balance from August to November, rose somewhat in December, while both the broadly defined money stock and the bank credit proxy increased substantially. Market interest rates, particularly short-term rates, have declined in recent weeks. After international

agreement was reached in December on new central exchange rates and on wider margins of permissible variation, market exchange rates for major foreign currencies against the dollar initially moved to levels a little above their new lower limits. The volume of capital reflows to the United States has been modest, however, and the underlying U.S. balance of payments remains in deficit. 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, while taking account of international developments and the forthcoming Treasury financing, the Committee seeks to promote the degree of ease in bank reserve and money market conditions essential to greater growth in monetary aggregates over the months ahead.

Secretary's Note: On January 12, 1972, Mr. Brimmer advised the FOMC Secretariat that he had voted against the proposed directive for the following reasons: He felt that the Committee properly had not accepted draft alternative B which would have established total reserves as the operating target until the next meeting of the Committee. He thought that the preferred course was to await the report of the committee on the directive (chaired by Governor Maisel), which was virtually ready for consideration by the Open Market Committee after nearly two years of effort. He noted that the directive committee was expected to recommend adoption of some version of a reserve target. While the proposed directive was in the form of alternative A (which Mr. Brimmer favored), the special emphasis on reserves as interpreted by the Chairman, in Mr. Brimmer's opinion, amounted to a "de facto" introduction of total reserves as an operating target. Mr. Brimmer also felt that the Committee should have had more discussion of the content and implications of the proposed compromise directive. Consequently, while Mr. Brimmer favored the policy objectives

specified in the compromise directive, he concluded that the form and interpretation of the operating instructions to the Manager were inappropriate.

Under date of January 17, 1972, Mr. Hayes submitted the following statement for inclusion in the record:

"My dissent was based on two major considerations. First, I felt that the great emphasis placed on the attainment of a total reserve target represented a retrogressive step. While the use of a total reserve target may have a superficial appeal on the ground that it is a quantity which the System is reasonably able to control, it is much less meaningful than other measures, such as the money and credit aggregates and interest rates, as an instrument for carrying out our basic economic objectives. Second, I felt most reluctant to issue a directive which might involve a very substantial further easing of money market conditions, since we have already moved rapidly in this direction and since the economic outlook appears to have improved somewhat in recent months. I felt concern over the risk that a further sharp decline in short-term interest rates might subject financial markets to unnecessary whipsawing and might tend to rekindle inflationary expectations."

Under date of February 10, 1972, Mr. Kimbrel advised, in explanation of his dissent, that he favored a policy of supplying reserves at a rate that would accommodate orderly economic expansion. However, he believed that the policy directive implied the possibility of pushing short-term rates down to unsustainably low levels and carried with it too high a risk of future excessive rates of growth in the monetary aggregates.

Chairman Burns asked Mr. Holmes to comment on the recommendations contained in his memorandum to the Committee entitled "Rate on System Repurchase Agreements," and dated January 7, 1972.[1/]

Mr. Holmes noted that his memorandum contained two recommendations. One was to continue until the close of business on

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

February 15, 1972, the date tentatively set for the next Committee meeting, the suspension of the lower limit on the repurchase agreement rate employed by the Federal Reserve Bank of New York, as specified in paragraph 1(c) of the continuing authority directive. The second recommendation was to establish a staff committee to investigate whether the Committee should retain its long-standing rule regarding the limit on RP rates; or whether it should consider other options that might provide additional flexibility on a more permanent basis, or that might provide for a competitive determination of repurchase rates which in effect would let the market decide the rate.

As indicated in the memorandum, Mr. Holmes continued, the first recommendation had been advanced because of an expectation that the circumstances which had made the recent suspension desirable might also exist during the next several weeks. As he had noted earlier, however, the lower limit on RP rates would not pose any problem at the moment because of the sharply lower average issuing rate in yesterday's auction of three-month Treasury bills. The Committee might still want to renew the suspension of the lower limit, in view of the possibility that the present situation would not persist; or it might prefer to let the suspension lapse, on the understanding that he would recommend a new suspension if developments suggested the need for one.

Mr. Mayo said that he thought the latter course would be preferable, and other members agreed. Accordingly, no action was

taken to renew the suspension of the lower limit on the repurchase agreement interest rate.

With respect to Mr. Holmes' second recommendation, Mr. Mitchell said he thought the indicated study would be desirable. Indeed, he would favor having the scope of the study broadened to include an analysis of possible alternatives to the extensive use of repurchase agreements, including outright purchases of Treasury coupon issues and agency issues.

Mr. Robertson endorsed Mr. Mitchell's suggestion. He added that when the Committee had originally decided--over his strong objections--to authorize the use of an RP rate below the discount rate, it had also agreed that the lower rate should be used sparingly. In his judgment actual use had not been sparing. Perhaps that had been the proper course, but the question was certainly worth study.

The Chairman then asked whether there were objections to the proposed study. When none was expressed, he named Mr. Axilrod as chairman of the staff committee to carry out the study and Messrs. Sternlight of the New York Bank and Scheld of the Chicago Bank as members.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period December 14, 1971, through January 5, 1972, and a supplemental

report covering the period January 6 through 10, 1972. Copies of these reports have been placed in the files of the Committee.

> By unanimous vote, the System open market transactions in foreign currencies during the period December 14, 1971, through January 10, 1972, were approved, ratified, and confirmed.

Mr. Bodner remarked that, as noted in the written reports, the System had made further repayments of $35 million during the period on its swap commitments to the National Bank of Belgium. Nine System drawings, totaling $360 million, would mature in the period from February 4 through February 25. The individual drawings had been renewed one to three times before. He could not say at this point how much progress would be made in coming weeks in further reducing the System's swap debt to the Belgians, and he recommended that the drawings in question be renewed again if necessary. Since the System had been making continuous use of the Belgian line for more than a year, express action by the Committee was required if the drawings were to be renewed.

> By unanimous vote, renewal of the nine System drawings on the National Bank of Belgium maturing in the period February 4-25, 1972, was authorized.

Mr. Bodner noted that the System had made initial repayments of $35 million during the period on its swap debt to the Bank of England. The balance of that drawing, amounting to $715 million,

would mature for the second time on February 17, and he recommended its renewal.

> Renewal of the System's drawing on the Bank of England maturing on February 17, 1972, was noted without objection.

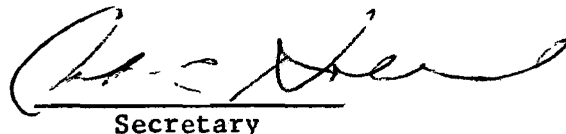
Finally, Mr. Bodner said, four System drawings of Swiss francs, totaling $1.6 billion, would mature in the period February 10 through February 18. They included a $600 million drawing on the Bank for International Settlements, which had been renewed once, and three drawings on the Swiss National Bank, totaling $1 billion, which had variously been renewed once or twice. He recommended that the drawings in question be renewed again at maturity.

> Renewal of the System's Swiss franc drawings on the Bank for International Settlements and on the Swiss National Bank maturing in the period February 10-18, 1972, was noted without objection.

Chairman Burns suggested that the Committee confirm the tentatively scheduled date for its next meeting, subject to the understanding agreed upon earlier that it might prove necessary for the Committee to hold an interim meeting.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, February 15, 1972, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

CONFIDENTIAL (FR) January 10, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on January 11, 1972

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services increased more rapidly in the fourth quarter than it had in the third quarter, but the unemployment rate remained high. In recent weeks wage and price developments have reflected some increases that had been deferred under the 90-day freeze; among proposed increases submitted to the Pay Board and Price Commission some have been approved but others have been cut back or not approved. The narrowly defined money stock, which had not grown on balance from August to November, rose somewhat in December, while both the broadly defined money stock and the bank credit proxy increased substantially. Market interest rates, particularly short-term rates, have declined in recent weeks. After international agreement was reached in December on new central exchange rates and on wider margins of permissible variation, market exchange rates for major foreign currencies against the dollar moved to levels a little above their new lower limits, and there has been a moderate volume of capital reflows to the United States. 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, while taking account of the forthcoming Treasury financing, the Committee seeks to promote the degree of ease in bank reserve and money market conditions essential to greater growth in monetary aggregates.

Alternative B

To implement this policy, while taking account of the forthcoming Treasury financing, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying the bank reserves needed to support greater growth in monetary aggregates; provided that money market conditions do not fluctuate over an unduly wide range.