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, February 15, 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, Eastburn, Swan, and Winn, 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. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Eisenmenger, Garvy, Gramley, Hersey, Scheld, Solomon, Taylor, and Tow, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Cardon, Assistant to the Board of Governors
Mr. Altmann, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Bryant, Director, Division of International Finance, Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Gemmill, Associate Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Rehanek, Secretary, Office of the Secretary, Board of Governors

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

Chairman Burns noted that on January 26, 1972, by a vote of ten 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 the close of business on February 15, 1972.

With Mr. Robertson dissenting, the action of members of the Federal Open Market Committee on January 26, 1972, suspending until close of business on February 15, 1972, 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 this action for the same reasons that had led him to dissent from the action itself.[1] He noted that at the January meeting of the Committee he had voted against ratification of a similar action taken in December, from which he had also dissented.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on December 14, 1971, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on December 14, 1971, was accepted.

The Chairman invited Mr. Brimmer to report on the recent meeting of the Economic Policy Committee of the OECD that he had attended.

Mr. Brimmer noted that the Economic Policy Committee had met in Paris for a day and a half on February 1 and 2. The EPC

1/ In casting his negative vote on January 26, 1972, Mr. Robertson had filed the following statement with the FOMC Secretariat: "I see no justification for increasing the subsidy to dealers in Government securities by making loans to them (in the form of repurchase agreements) at lower and lower rates of interest." He preferred that reserves be injected into the banking system by outright purchases of Treasury securities in the open market.

meeting, which was followed immediately by a meeting of Working Party Three, had been called partly in response to a suggestion by the American delegation in November. The purpose was to consider the prospects for economic growth in the OECD community following the realignment of exchange rates that many observers had expected to occur around the turn of the year.

Much of the discussion had focused on the United States, Mr. Brimmer observed. There was considerable criticism of U.S. monetary policy, but it came almost exclusively from representatives of smaller countries. The larger countries--and some small ones--appeared to understand that the objective of U.S. monetary policy, to stimulate domestic growth, was vital to them as well as to the United States. It was suggested by several countries that the U.S. authorities consider imposing additional constraints on capital outflows. While the matter was not stressed in the open session, it was also mentioned by representatives of a few additional countries during informal conversations.

One attitude underlying much of the discussion, Mr. Brimmer continued, was disappointment that the United States had not experienced substantial reflows of short-term capital following the Smithsonian agreement. As has been reported in press accounts of the meeting, the explanation for the lack of such reflows offered by the U.S. delegation was not fully acceptable.

Chairman Burns then asked Mr. Solomon to report on developments at the subsequent WP-3 meeting.

Mr. Solomon observed that the discussion at the WP-3 meeting had focused on the current account effects of the December exchange rate realignment and on recent and prospective capital flows. He would cover the highlights of the meeting briefly, reporting the attitudes and opinions of European officials as expressed in both the open sessions and personal conversations. It was generally agreed that the basic effects of the realignment would not be evident for some time and, in particular, that there would be very little impact on the U.S. trade balance in 1972. That was because of two factors which would be working in the wrong direction in the short run. The first, the so-called "terms of trade" factor, might be explained by noting that the initial effects of a devaluation were on prices, and they tended to have perverse consequences for the balance of trade; the positive consequences appeared only later, when the quantities traded began to respond to the new exchange rates. Secondly, cyclical forces would be tending to work against improvement in the U.S. trade balance in 1972 if, as expected, economic activity would be expanding more rapidly in the United States than in Europe.

With respect to capital flows, Mr. Solomon continued, it was recognized that the small reflows that had occurred since the Smithsonian agreement had been sufficient to finance the basic deficit in the U.S. balance of payments. Moreover, it was the consensus of the working party that a gradual reflow throughout the year, covering a continuing deficit in the basic U.S. payments balance, would be a rather satisfactory outcome. There was uncertainty, however, as to whether the reflow would be large enough even for that purpose. Some European officials were worried that the loss of confidence in the dollar that had occurred in 1971 would make private investors who had moved out of dollars reluctant to move back in, and would lead some central banks to diversify their reserves by shifting some holdings from dollars into guilders, marks, or other currencies. Libya was the only major reserve holder known to be shifting out of dollars, but it was possible that other countries also were doing so.

In the view of a number of European officials, Mr. Solomon remarked, confidence would be helped by some gesture indicating that the United States was concerned about the situation--perhaps taking the form of policy actions directed at raising short-term interest rates in the United States relative to those abroad. Actually, as the Europeans had pointed out, since the Smithsonian agreement short-term rates had dropped more sharply in the United States than in Europe. The Europeans also were disturbed by the reports they had heard to the effect that this country might relax its capital controls.

As to the dangers in this situation, Mr. Solomon continued, he might note first that some of the Europeans were genuinely concerned about the risk of another wave of speculation in foreign exchange markets. Reports that particular countries were making large-scale purchases of dollars to defend the new central exchange rates could, they feared, trigger heavy speculation into their currencies. Secondly, the Europeans might well decide to reimpose some of the stringent controls they had in effect from August 15 to December 18, 1971, in an effort to limit inflows of funds. Such a development would lend encouragement to the forces now at work in Europe which sought to shape the Common Market into a more restrictive bloc.

Turning to the implications for U.S. monetary policy, Mr. Solomon said that, if it were consistent with domestic objectives, some upward movement in short-term rates in this country would be helpful in restoring confidence in Europe and in insuring sufficient reflows of short-term funds to cover the basic deficit in the U.S. payments balance. One possibility would be for the System to concentrate its open market purchases in the coupon rather than the bill area, and perhaps to make offsetting sales of bills and purchases of coupon securities. Such an "operation twist" could go some distance in allaying concern abroad.

Chairman Burns said that while he thought there had not been much gain from the System's earlier attempts at an operation twist he did not feel strongly on the matter and would not rule out another such operation. Putting that question aside, he wondered why foreign central banks did not undertake to manage their portfolios of U.S. securities in a manner that would have the same results--in effect, carrying out their own operation twist.

Mr. Daane said it was his impression that the constraints under which some foreign central banks operated would not permit them to invest in longer-term U.S. securities. In some cases, of course, those constraints might be self-imposed.

Mr. Brimmer said he had pointed out at the EPC meeting that to some extent recent downward pressures on short-term rates in the United States reflected purchases of U.S. Treasury bills by foreign central banks. After the meeting he had pursued the point in private conversations with certain central bankers, asking in particular why they did not rearrange their portfolios to increase their holdings of longer-term securities. A few indicated that they were in fact doing that to some extent. However, the replies of two central bankers tended to support Mr. Daane's observation. One said explicitly that the appearance of long-term holdings in the central bank's portfolio would necessitate explanations at home of a kind not required for bill holdings.

Chairman Burns remarked that any foreign central bankers in such a situation might want to take account of the fact that the Federal Reserve also would be under an obligation to explain its actions if it were to encourage a rise in domestic short-term interest rates.

Mr. Coombs remarked that there might well be scope for portfolio shifts by the Germans and Japanese; indeed, he had discussed the possibility with Japanese officials at the Basle meeting this past weekend. For most European central banks, however, such shifts probably would be precluded by the statutes under which they operated. That was clearly the case in Switzerland and probably also in the Netherlands and Belgium. As to the British, he suspected that a good deal of salesmanship would be required to persuade them to modify their portfolio at this time, in light of the problems their country was now facing as a result of the coal strike.

Mr. Daane asked whether the concern now apparent in Europe was related solely to the current stance of U.S. monetary policy and the level of short-term interest rates here or whether it had a broader basis.

Mr. Solomon replied that the concern was clearly a broad one. While there were, of course, differences among individuals, there seemed to be a widespread fear that the United States had adopted a posture of "benign neglect" and that it would seek to preserve the current situation, including a nonconvertible dollar, without much concern for the rest of the world.

Mr. Brimmer added that one or two of the delegates to the EPC meeting had been rather harsh in their criticism of the U.S. budget. They did not seem to understand the relationship between the budget deficit and the amount of unutilized capacity in this country.

Chairman Burns then asked Mr. Coombs to report on the February Basle meeting from which he had just returned.

Mr. Coombs remarked that on Saturday afternoon the Standing Committee on the Euro-dollar market had met to review the replies to a BIS questionnaire regarding their experience with the Euro-dollar market. In general, a sizable majority of the foreign central banks seemed to feel that the Euro-dollar market had interfered with their policy objectives by amplifying the flows of short-term funds across the exchanges. On the other hand, only a small minority of the banks seemed to favor moving toward multilateral supervision of the market, although all of them were prepared to talk about it.

At the governors' meeting on Sunday afternoon, Mr. Coombs continued, President Zijlstra called for a review by the governors at the March meeting of the findings of the Standing Committee, with particular reference to these three policy issues: (1) What could countries on the receiving end of Euro-dollar flows do to minimize any adverse effects? (2) What could countries supplying funds to the Euro-dollar market do to control excessive outflows? (3) What institutional changes--such as reserve requirements on Euro-dollar deposits--might be envisaged to eliminate, as Milton Gilbert put it, the "privileged" position of the Euro-dollar market?

Mr. Coombs said he thought the main target of that policy discussion would be the reluctance of the German Government to control short-term capital inflows, which more than accounted for the entire increase in the reserves of the German Federal Bank since 1968. If the Germans had been prepared to use such controls, the world would have been quite a different one today.

In the go-around of individual country positions, Mr. Coombs remarked, Governor O'Brien of the Bank of England had reported some revival of activity, but all of the other governors saw a continuation of slack conditions in their countries for at least the next six months. He had received the impression that some further easing of European credit markets might be in the offing. The discussion at the Sunday evening governors' dinner was devoted largely to conditions in the exchange market and he would comment on that discussion in connection with his regular report on the market.

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 January 11 through February 9, 1972, and a supplemental report covering the period February 10 through 14, 1972. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs said that between the date of the Smithsonian meeting, December 18, 1971, and the year-end, the dollar had shown considerable strength on the foreign exchanges. The effective revaluation of most of the foreign currencies concerned was greater than the market had been expecting only a few weeks before, and the stage had seemed set for some sizable return flows of speculative money. Sterling, the French franc, the Swiss franc, the mark, and the yen all traded close to their new floor rates. After the turn of the year, however, market sentiment had shifted to an increasingly pessimistic view, and that set off a new wave of speculation against the dollar which might have crested out on February 2. On that day the London gold price rose to $49.25, while most European currencies, including sterling, rose above par and several moved to their new ceilings.

Mr. Coombs remarked that there were a number of reasons for that deterioration of sentiment, some technical and some more basic. Among the technical factors, the delay in going to Congress for an increase in the gold price until trade negotiations with the Common Market were completed naturally had led to hedging against the risk that a breakdown in the trade negotiations might frustrate the promised change in the price of gold and put everyone back on a floating rate basis. The delay on the gold bill also encouraged rumors that either the Administration or Congress might suddenly go for a much bigger gold price increase. The market was also fearful of protectionist amendments to the gold bill, which again might undermine the December 18 agreement.

Mr. Coombs noted that there was also a great deal of talk in the market about the risk, in the absence of convertibility, that certain European central banks might refuse to take in any sizable amount of inconvertible dollars if their currencies rose to the ceiling--either reimposing controls or allowing their currencies to float. On February 2, selling pressure on the dollar drove several European currencies to their new ceilings, but the central banks concerned showed no hesitance in taking in dollars, in one case on a fairly sizable scale. That relieved, at least temporarily, one major source of market anxiety, and further reassurance was provided that same day by a Treasury promise of early submission to Congress of a bill to raise the price of gold to $38.00, no more and no less. Since then the London gold price had fallen back somewhat and the dollar had strengthened against most major foreign currencies. Early Congressional enactment of a reasonably clean gold price bill would encourage a further recovery of market sentiment.

However, Mr. Coombs observed, there remained a great deal of market apprehension over more basic factors, with much attention given to estimates of the U.S. budget deficit. Still another bearish factor in market thinking had been the publicity given to recent official estimates, both here and abroad, that it might take several years to eliminate the U.S. payments deficit. Finally, the market was well aware of another unsettled policy issue, which had so far received relatively little press coverage. That was the issue of whether the Common Market countries would soon move to narrow the band of fluctuations among their currencies. With the present spread of 4-1/2 per cent against the dollar, the potential range of fluctuation between, say, the mark and the French franc, was 9 per cent, which obviously did not fit too well with the concept of an integrated Common Market. Accordingly, there had been a revival of intense discussion among the Common Market countries of the Werner Plan which called for a narrowing of the band of rate fluctuations among the European currencies. Over time, the constellation of Common Market exchange rates might move in unison over the entire 4-1/2 per cent range against the dollar now permitted by the International Monetary Fund, but in the short run--perhaps for many months at a stretch--the range of fluctuation might be no more than 2 per cent. Assuming that such a 2 per cent range were initially centered on the new parity rates, the effective floor for sterling, for example, would not be the present $2.5471, but the very much higher figure of $2.58.

Against the background of those fresh uncertainties emerging since the turn of the year, Mr. Coombs observed, it was not surprising that treasurers of U.S. corporations and others involved in the flight from the dollar last year had thus far delayed in bringing their money back and taking their profits. The decline in U.S. interest rates during January had undoubtedly strongly reinforced that wait-and-see attitude.

At the BIS meeting this past weekend, Mr. Coombs said, he had found that most of the central bankers present believed that lack of confidence was the primary factor holding back a return flow of funds. In that connection, they felt that the delay in the gold price legislation had been a particularly unfortunate development. They were strongly of the view that confidence had been seriously disturbed not only by the factors he had noted but also by the impasse between the United States and Europe on the matter of reactivating the Fund, with particular reference to the British debt repayment. That, they argued, had cast a shadow over the future of special drawing rights and had contributed to the revival of speculation in the gold market. They expressed willingness to engage in some kind of a burden-sharing exercise to reduce the cost to the United States of getting the British repayment through the Fund. Their feelings on that point were running pretty high and could easily flare up in public recriminations unless some effort was made to resolve the issue.

More generally, Mr. Coombs observed, the governors at Basle felt that a resumption of discussions on ways and means of eventually restoring convertibility of the dollar would promote market confidence that the world was not about to break apart into antagonistic monetary blocs and that some cooperative solution would be found. They fully accepted the necessity of an interim period in which the dollar had to remain inconvertible.

On the interest rate question, Mr. Coombs reported that the governors at Basle felt--as he did--that the gap between rates here and abroad had been an important deterrent to the return flow of funds but was clearly secondary to the confidence problem. The three-month rate in Switzerland, for example, was now running around 1 per cent, compared with a rate of 5 per cent in the Euro-dollar market. Yet outflows from Switzerland continued to be frustrated by a premium of more than 4 per cent on the forward Swiss franc, reflecting the continuing lack of confidence.

To summarize the governors' position on interest rates, Mr. Coombs continued, they would clearly be distressed if U.S. rates fell further, and they would welcome a rising trend if business activity picked up. However, they fully understood the U.S. concern with a stubbornly high unemployment rate, and for the time being they were unlikely to do much complaining about current rate levels. At least, they had not complained much at the Basle meeting. Their main concern was the risk of a new crisis of confidence in the exchange market if negotiations were not resumed between Europe and the United States on the future evolution of the world financial system. Such a crisis of confidence might well wreck the December exchange rate agreement with potentially serious repercussions on confidence here at home.

Mr. Daane referred to Mr. Coombs' comments regarding the discussions within the Common Market of a move to a narrower band of fluctuations for their currencies and asked whether the staff would prepare an analysis of the implications of such a development.

Mr. Coombs said he had planned to prepare a memorandum on that subject.

> By unanimous vote, the System open market transactions in foreign currencies during the period January 11 through February 14, 1972, were approved, ratified, and confirmed.

Mr. Coombs then reported that three System drawings on the German Federal Bank, totaling $50 million, would mature for the fourth time on February 29, 1972. He did not think it would be feasible to repay those drawings until after enactment of the gold price legislation and that might not have been accomplished by the maturity date. The drawings in question had been initiated on May 7, 1971, so that if they were renewed on February 29 and remained outstanding for another full three-month term the German swap line would have been in active use for more than a year. He recommended that the Committee expressly authorize renewal of those drawings for further periods of three months, in accordance with the terms of paragraph 1D of the authorization for System foreign currency operations.

In reply to a question by Mr. Daane, Mr. Coombs said that System officials had been discussing the basis on which outstanding drawings might be liquidated with officials of the foreign central banks involved. However, it was the position of the U.S. Treasury that no final arrangements for repayment should be made until after the gold bill had been enacted. In the interim, the other parties had been willing to renew the drawings as they came due, and he thought the German Federal Bank would not object to renewing the drawings in question. Assuming the other parties honored the revaluation clauses in the swap contracts, it was likely that the terms on which the drawings were ultimately settled would involve smaller losses to the System than would be incurred if the drawings were repaid now with currencies acquired in the market.

Mr. Daane said he would favor authorizing renewal of the drawings, and Mr. Robertson remarked that there appeared to be no reasonable alternative.

By unanimous vote, renewal for further periods of three months of the three System drawings on the German Federal Bank maturing on February 29, 1972, was authorized.

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 business news that has become available since early January shows no signs of a further quickening in the rate of expansion from the fourth-quarter pace. True, there was a substantial rise in nonfarm employment in January, on a seasonally adjusted basis, and other indicators also seem to be pointing to an improved labor market. But our preliminary estimate is that the industrial production index increased only 0.3 of a percentage point in January, following a downward revised 0.6 point gain in December. And retail sales recovered very little in January, according to the advance report, after what still appears to have been a disappointing Christmas season in aggregate sales.

We continue to believe that the fourth-quarter upturn, which was related heavily to a revival in steel production and a temporary rise in auto sales, will soon broaden to include other sectors. This view is supported by the good rise in manufacturers' new orders in the last quarter of 1971, paced by orders for capital equipment, consumer household durables, and steel. It is also reflected in many of the District reports in the red book[1/] this time, which refer to improved orders, sales, and optimism in a variety of business lines. The leading indicators have been moving upward, with December particularly strong, and the sizable rise in stock market prices over the last three months suggests increased confidence in the business outlook.

But what is needed is some new spur to get the cumulative forces of recovery in motion. We had thought that the impetus would come from consumer spending, but the

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

recent performance in this area has not been very promising. Business investment seems to be in a rising trend again, but any near-term upsurge is most unlikely. Residential construction has already had most of its rise; the surprising spurt in housing starts in December mainly reflected a year-end bulge in Government subsidized activity. And a sizable pickup in inventory accumulation, although we expect it this year, probably will require accompanying strength in final sales before it can gain real force.

The new budget document, on its face, promises the prospect of the new stimulus needed. Spending is projected to rise sharply, particularly in the remaining months of this fiscal year, and the estimated budget deficit is a good deal larger than we had been expecting. On closer inspection, however, the actual fiscal stimulation likely to be forthcoming is more conjectural and may in fact be little larger than we had previously been counting on. In view of the unusual complexity of the subject, I have asked Mr. Wendel to present a brief review of our analysis and interpretation of the budget figures. Some charts and tables[1/] to support his presentation have already been distributed and are before you.

Mr. Wendel's comments on the budget were as follows:

A year ago, the staff estimate of Federal outlays for fiscal year 1972 was $235 billion--about the same as what we are now estimating. Actual Federal spending in the half year ended in December, however, was at an annual rate of only $223 billion. The recent new budget is scheduling a large bulge of spending between now and June, and a much slower growth thereafter. Much of this planned bulge in spending will probably influence the economy gradually, over a longer period, and hence it may be useful to look at budget projections of growth rates in spending for calendar year 1972 as a whole. Chart I shows these growth rates on an NIA basis with the dashed lines representing percentage increases for calendar year 1972. Total spending is scheduled to increase by 13 per cent, substantially faster than the 8 per cent growth in 1971. A large part of this fast growth rate is made up of a 37 per cent scheduled increase in grants to State and local governments, as shown in the bottom section of the chart. Measured net of grants, the increase in calendar year 1972 shrinks to 9 per cent--just about the same as the projected increase for total GNP.

1/ Copies of these materials are appended to this memorandum as Attachment A.

The rapid growth in grants shown in Chart I includes a full year of general revenue sharing at a \$5.0 billion annual rate, as assumed in the budget. Other grants are projected to rise at a 20 per cent rate. The evidence of the last two years, when grants were also growing rapidly, is that they have mainly served to maintain, rather than to increase, the rate of expansion of State and local spending--during a period when there was a relative shrinkage in tax receipts. Chances are that State and local spending growth in 1972 will again be about 11 per cent, as in the previous two years. Especially in regard to general revenue sharing funds, there are likely to be significant delays in planning and legislative action before these funds generate rising State and local outlays.

Turning to Federal spending growth in other categories, the most significant feature of current budget plans is the shift to an increase in defense outlays. A good part of this shift represents pay increases, but a portion represents a turn-around in procurement from decreases to increases.

Table 1 shows increments in spending at seasonally adjusted annual rates by half years as projected in estimates by the Board's staff. These differ from budget estimates in that general revenue sharing is assumed to begin at mid-year 1972, but not to be retroactive. Three types of spending are highlighted in the table: (1) a collection of fairly uncontrollable outlays, such as pay increases and social security payments, (2) a collection of items subject to more control such as defense and nondefense purchases--other than pay raises--and grants to States, and (3) general revenue sharing. Uncontrollable outlays increase fairly regularly, by amounts ranging approximately between \$6 billion and \$8 billion. The controllable expenditures, however, are scheduled to spurt in the current half year and then taper off sharply.

The economic impact of this acceleration is likely to be more gradual. Even in the case of purchases, a sudden acceleration of orders and deliveries will probably be met in the short run by running down inventories. Also, the planned acceleration might not all materialize. Military orders have been about level for the past several months, and thus the usual advance indicator of larger purchases is lacking so far.

Table 2 shows the impact, by half years, of recent changes in the tax structure. In the current half year tax cuts amount to \$4 billion at an annual rate, and after that there are little further changes on balance. The figures shown here are Board staff estimates which give more weight to the current tendency for overwithholding than the official budget does. It is our view that recent sizable cuts in personal taxes are being offset currently by a swing from underwithholding to overwithholding in withheld taxes. The impact of this overwithholding is to spread the economic effects of recent tax cuts over a longer period.

On a full employment basis, staff estimates indicate a shift from a small surplus in calendar year 1971 to a $3.4 billion deficit at an annual rate in the first half of 1972, as shown in the middle panel of the last chart. The deficit then rises to $9.5 billion in the second half of 1972.

I think that the $3.4 billion full-employment deficit in the first half of 1972 may be fairly representing the degree of fiscal stimulus for that period. The computed high-employment deficit for the second half of 1972--at $9.5 billion--probably overstates fiscal stimulus, however, because a large part of the shift toward deeper deficit represents increases in grants to State and local governments.

We believe the Treasury will not need to borrow as much through June as is projected in the budget. Expenditures are unlikely to include general revenue sharing and receipts are likely to include some addition from overwithholdings. Also, the cash balance can be drawn down somewhat. Our projection calls for $32 billion of net cash borrowing during fiscal 1972, which leaves $10 billion in net borrowing for the four months beginning in March.

Mr. Partee then continued with the following comments:

The GNP projection presented in the green book[1/] attempts to take into account recent economic information, as well as the new budgetary numbers, as they apply to the outlook for calendar 1972. We have incorporated the official expenditures estimates as given, except that revenue sharing is not assumed to take effect before mid-year. Tax receipts are related to our specific GNP projection, and personal tax payments have been raised by an additional $2 billion over budget estimates for the calendar year to reflect what we expect to be the full shift from underpayment to overpayment in personal withholding schedules.

So adjusted, the effect as compared with our earlier budgetary estimates is not much more stimulative. Federal

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

purchases rise by the same amount in the course of the year as previously estimated, although there is more of a bunching of the increase in the second quarter. The principal increase in other Federal outlays is in revenue sharing and other transfers to State and local governments, but it seems doubtful that expenditures for goods and services will be much influenced in the initial months of a general revenue sharing program. The over-all effect, therefore, will most probably be to increase the GNP only marginally for this calendar year, although the longer-run impact could be more substantial.

This analysis of the budget, together with the recent rather disappointing business news, has led us to scale down our GNP projection slightly from what it was five weeks ago. The over-all increase for 1972 over 1971 is now projected at $96 billion, as compared with $100 billion in early January; the expansion in real GNP is projected to be 5.6 per cent, compared with 6 per cent before. One reason for the reduction in these year-over-year gains is the downward revision of the official GNP estimates for 1971, which were relatively large in the latter part of the year. But our view of the outlook has also softened somewhat, with the prospect--supported by both the recent data and attitude surveys--that consumer spending may not be quite so ebullient as we were expecting earlier, and with a more sober evaluation of the prospects for quick improvement in our net foreign trade balance stemming from the December currency realignments. Though our current projection could now prove to be too conservative, it seems to me that the greater danger at this juncture lies in the possibility of a shortfall of GNP growth this quarter that would tend to put us behind all year.

As a part of the rethinking of our judgmental projection for 1972, we reran our quarterly econometric model to incorporate the new budget figures and revised GNP data for 1971. Two alternative monetary assumptions were used for this exercise--one calling for expansion in narrowly defined money at a 6 per cent rate and the other embodying M_1 growth of 8 per cent. The model results using 6 per cent monetary growth were somewhat below our judgmental projection, in terms of nominal GNP, while the 8 per cent M_1 assumption produced results that were slightly above. It is worth noting, however, that the differences in monetary growth rates assumed do have a significant effect in the model on GNP growth over the course of the year. Comparing the projected fourth quarter of 1972 with the fourth quarter of 1971, the version of the model incorporating 8 per cent growth in M_1 resulted in an $11 billion larger increase in nominal GNP, real growth averaging 7 per cent rather than 6 per cent, and a decline in the unemployment rate by the fourth quarter to 5.2 per cent rather than 5.6 per cent. Short-term interest rates are indicated to rise under both assumptions, but by 50 basis points less in the higher money growth model.

I have reported the results of our econometric model in some detail, not because I believe that they are likely to be more accurate than our judgmental projection, but in order to show the possible incremental effects of different monetary assumptions that are allowed to persist for some period of time. In view of the very real possibility that economic recovery this year will prove somewhat less vigorous than we were anticipating a few months ago, and in view of the substantial amount of unused resources currently available to support faster economic expansion, I can see no good reason for rejecting the opportunity to achieve a moderate incremental acceleration in the pace of economic activity. If growth in the narrowly defined money supply is permitted to accelerate to around an 8 per cent rate, moreover, our economic projections--whether judgmental or econometric--indicate that the Committee can safely be prepared to live with such a rate extending well into 1972.

Mr. Daane asked whether one of the factors underlying the ·· back in projected growth of GNP was a staff judgment that there had been a weakening in the state of public confidence.

Mr. Partee replied that it probably would be more accurate to say there had been a weakening in the staff's confidence in its earlier projections rather than in its assessment of public confidence. Although the projections of net exports had been reduced considerably, most of the cutback was in the category of consumer spending. Last fall the staff had anticipated that various factors would combine to produce a substantial step-up in spending by consumers, including rising employment and income, growing confidence as the wage-price controls that had just been put in place proved their effectiveness, and--as a consequence of the latter--a reduction in the high rate of personal saving. The projections had been reduced when incoming data--including retail sales figures showing no net growth over the months of December and January--indicated less strength than anticipated. Also, with one exception recent surveys of consumer attitudes had not suggested any appreciable improvement in confidence.

Mr. Partee said he suspected that the recent poor performance of retail sales was due at least in part to special factors such as over withholding of income taxes, and he still expected consumers to become more confident as employment opportunities expanded. As he had indicated, however, he thought there was a considerable risk that the first-quarter rise in GNP would be below the $30 billion rate currently projected.

Mr. MacLaury referred to the staff's exercise involving the econometric model and asked whether the use of alternative assumptions about the rate of money growth yielded different projections for the GNP deflator in 1972.

Mr. Partee replied that the model showed the same rise in the deflator between the fourth quarters of 1971 and 1972 under both monetary assumptions. In part that was a consequence of the relatively long lag assumed in the model in the response of prices to changes in the rate of activity. The more important reason, however, was that the volume of unemployed resources was expected to be substantial throughout the year even under the faster of the two rates of growth in money. If, as projected under the faster monetary growth assumption, the unemployment rate in the fourth quarter was still as high as 5.2 per cent, rising demands were not likely to put much upward pressures on prices.

Mr. Morris remarked that one of the directors of the Boston Bank had expressed the view that the budget for fiscal 1973 was likely to be substantially more expansionary than appeared on the surface because the Defense Department had changed its procedures and would no longer be making payments for work in process. Thus, a good deal of defense work that under previous procedures would have been reflected in the 1973 budget would be privately financed in that year and would not affect the budget figures until fiscal 1974. He asked whether account had been taken of that factor in the staff's projections.

Chairman Burns said he had understood from an earlier staff analysis that there would be a substantial volume of advance payments to defense contractors in June of this year.

Mr. Wendel agreed that the staff had so indicated. He had also been informed, however, that the Defense Department had recently tightened its regulations regarding advance payments. Apparently the change in rules would not preclude a bunching of payments just before the end of the current fiscal year.

Mr. Partee remarked in response to Mr. Morris' question that the staff projections allowed for an increase in defense orders of about 10 per cent over calendar 1972 from the low that had been reached in the fourth quarter of 1971. That projection had been based on earlier indications of a prospective increase in new orders for defense goods and had not been modified significantly when the budget estimates had become available.

Mr. Heflin noted that last week the Richmond Bank had completed a special survey of the manufacturing and trade sectors of the Fifth District economy. On the whole, he had found the results to be quite encouraging. The survey revealed rather pronounced indications of a step-up in inventory accumulation in both the retail and manufacturing sectors. It also showed substantial recent increases in manufacturers' new and unfilled orders. On balance, he had the impression that manufacturing in the District had improved significantly over the last month or two. The advances reported for North and South Carolina were outstanding and the reports for Virginia were nearly as good. The red book suggested a similar pattern in some other parts of the country. While such reports were not conclusive, they were widespread enough to warrant the Committee's attention.

Mr. Mayo said he had found Mr. Wendel's analysis of the budget quite in line with impressions he himself had formed in reading the document. He added that the small increase shown for defense spending in fiscal 1973 seemed clearly to be an understatement in light of the $6 or $7 billion increase in the obligational authority for that year. Accordingly, he was inclined to think that defense spending would involve more stimulation next year than the budget figures suggested.

Mr. Mayo then observed that capital goods producers in the Seventh District appeared on the whole to be slightly more optimistic than earlier. However, there were some rather puzzling differences in the attitudes of different producers. The explanation apparently was that equipment demand was good to excellent in connection with programs to modernize or to improve operating efficiency, but that it was not very good in connection with programs to expand capacity or to replace wholly outmoded plants. He might also note that the demand for heavy trucks was very good and it appeared likely that sales of such trucks in 1972 would be well above the record level of 1969.

Mr. Hayes remarked that his general reading of the economic signals was a shade more optimistic than that of the Board's staff. Although those signals were mixed, on balance they appeared to suggest slightly more strength than they had in the fall. Against the background of the improved performance of the economy in the fourth quarter, he thought the projection of a 6 per cent rate of real growth in 1972 was becoming increasingly realistic.

Admittedly, Mr. Hayes continued, the element of confidence was a big question mark. He suspected that consumer confidence was still somewhat impaired by doubts that the battle against inflation had been won--doubts that were due in part to the continuing increases in prices of food, transportation, and so forth.

Mr. Hayes said he had found the budget document rather disturbing in some respects even though one might question whether the deficit in the current fiscal year would actually reach the estimated level of $38.8 billion. He agreed that, from a strictly economic viewpoint, the fiscal stimulus being provided currently was appropriate. There was no doubt, however, that the size of the budget deficits for this year and the next had had an unsettling effect in the business and financial communities and had weakened confidence both domestically and in the foreign exchange market. Also, he was concerned that as an indirect consequence of the large budget deficits in fiscal 1972 and 1973 the Federal Reserve might be led to supply more bank reserves than would be consistent with an abatement of inflationary pressures. Certainly that had happened under similar circumstances in the past. Finally, he was concerned about the longer-run fiscal outlook. It seemed to him that increased taxes would be needed unless spending was brought under control.

With respect to the international situation, Mr. Hayes expressed the view that the intermittent weakness of the dollar reflected a lingering distrust of the new currency alignments and, to some extent, the adverse relationship of interest rates. Hopefully, that situation would improve over coming months. However, the possibility of major new pressures on the dollar could not be ruled out. More generally, he thought the Committee could not formulate policy on the assumption that the major international problems had been resolved and that international considerations could now be disregarded.

Mr. Coldwell said he expected economic activity to grow slowly but persistently over coming months. Two recent developments in the Eleventh District might be of interest to the Committee. First, a few of the smaller banks had evidenced an intent to invest some idle funds in the Euro-dollar market, making the placements through large correspondents. Secondly, the chief executive officers of some multinational firms with headquarters in the District had indicated that they planned to rely on resident financing of their plants abroad during the next few years, in view of the risk that restrictions would be imposed on international capital flows.

Mr. Heflin asked about the extent to which the sluggish performance of industrial production in January could be attributed to the temporary cutback in automobile output, and whether the staff would expect substantial increases in the production index in the next few months now that auto output was scheduled to rise.

Mr. Partee noted that industrial production would have to increase at a substantial pace if the staff's GNP projections were to be realized. Domestic auto assemblies, which had declined from an annual rate of 8.6 million units in December to 8.1 million units in January, were scheduled to rise to 8.3 or 8.4 million units in February and March. While that gain was not very large, it would contribute to the rise in the production index. Steel output also was expected to expand, as suggested by the reports in the red book for both the Cleveland and Chicago Districts.

In reply to a question by Mr. Daane, Mr. Partee said the decline in industrial production following the peak reached in September 1969 was not as great as in other cyclical downturns, but the recovery from the trough also was unusually slow. In January the index was still about 4 per cent below its peak. There was no precedent in the postwar period for so weak a recovery.

Mr. Winn asked about the indicators Mr. Partee had had in mind when he spoke about improved labor markets. It was his (Mr. Winn's) impression that while attitudes were improving employment prospects were not.

Mr. Partee noted that there had been a large gain in seasonally adjusted nonfarm payroll employment in January. Although one might want to reserve judgment about the implications of that rise, in view of the importance of seasonal adjustment factors for December and January in influencing the indicated change in employment between those two months, there were also other indicators suggesting improvement. They included a drop in unemployment insurance claims over the fall and winter and a rise in the index of help-wanted advertising. Also, the marginal indicators of accessions and layoffs in manufacturing had recently improved a little.

Chairman Burns said one should also note that the length of the workweek had dropped sharply in January after improving in December. On balance, the workweek had not lengthened significantly in recent months.

Mr. Brimmer observed that he was scheduled to testify before the Joint Economic Committee next week on the subject of minority employment. By way of preparation, he had asked Mr. Wernick to work with some of the Reserve Banks in obtaining manufacturers' assessments of their employment prospects for 1972. The results, which were in qualitative form, suggested some improvement in employment.

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 January 11 through February 9, 1972, and a supplemental report covering the period February 10 through 14, 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 since the January meeting of the Committee were conducted with a view to fostering a substantial growth in total reserves in January and then to maintaining steady conditions in the money market during the Treasury's February refunding.1/ As the written reports point out, total reserves grew at an annual rate of 28 per cent in January (on the basis of the old seasonal adjustment factors), somewhat

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1/ On January 21, 1972, the Secretary of the Committee had sent the following message to the members and other Reserve Bank Presidents:

"As you know, second paragraph of current economic policy directive issued by Federal Open Market Committee at its meeting on January 11 indicated that '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.' During the course of meeting Committee agreed that this language should be interpreted to call for letting the spirit of alternative B of the draft directives prevail by placing emphasis on supplying reserves to a satisfactory degree. Specifically, against background of staff projection for very sizable growth in total reserves in January, Desk was instructed to aim for growth in total reserves from December to January at annual rate in range of 20 to 25 per cent, lowering the Federal funds rate to 3 per cent if necessary to attain that objective.

"Current data for statement weeks ending January 5, 12, and 19 indicate that average level of M_1 thus far in January is no different from that in December as a whole, while M_2, credit proxy, and total reserves are up sharply--as expected. For January as a whole, Board staff is currently projecting growth in M_1 at annual rate of 3 per cent. M_2 is projected to rise at 13 per cent rate, and total reserves at rate of 28.0 per cent. A decline in total reserves, at an annual rate of 9.5 per cent, is projected for February. This decline primarily reflects a projected shrinkage of Government deposits, and staff judges that if funds rate is maintained in the neighborhood of currently prevailing level of about 3-1/2 per cent, sufficient reserves will be available to support February growth in M_1 and M_2 at projected rates of 10 and 10.5 per cent, respectively. (Footnote continued) above the upper end of the 20 to 25 per cent range specified by the Committee at its last meeting. In view of the continued sluggish performance of M_1 some overshoot appeared desirable. On the basis of the new seasonals that became available late in the period, January growth was somewhat less, but growth of total reserves in December and January combined was about the same. Meeting the reserve target involved a reduction of about 1/2 percentage point in the Federal funds rate on balance over the period and a very low level of member bank borrowing from the Reserve Banks. As I noted at the Committee meeting yesterday, the implementation of a reserve-oriented directive caused virtually no operational problems or disturbance to the money market. But this January experience cannot be taken as an indication that things will always go as smoothly under a less favorable set of circumstances.

As far as other interest rates are concerned, most short-term rates continued to decline, reflecting the

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(Footnote continued)

"If the Committee reacts affirmatively to the approach to operations in the first part of February outlined below, it is Chairman Burns' present judgment that there will be no need for Committee to meet again until February 15. Giving consideration to the directive language calling for account to be taken of the forthcoming Treasury financing, it could be construed that the Desk's objective henceforth, until the February FOMC meeting, should be to maintain money market conditions substantially unchanged; but that the Desk should adjust its opeiations within the limited range consistent with even keel should the monetary aggregates appear to be deviating appreciably from desired growth rates.

"Chairman Burns indicates that he favors this approach, and the System Account Manager advises that in his judgment the contents of this telegram constitute a reasonable and workable interpretation.

"Please advise whether you are in accord with this approach."

All Committee members (and all of the other Reserve Bank Presidents responding) indicated that they were in accord with the approach to operations described, except Mr. Robertson. The latter indicated that he was not in accord because the proposal involved a return to a "money market conditions" approach of the kind the Committee had moved away from at the January meeting.

ample state of both bank and nonbank liquidity. Thus, the prime rate was cut to as low as 4-1/2 per cent at three major banks with floating rates; consumer loan and mortgage rates were reduced by some banks; and rates on commercial paper, dealer loans, acceptances, and large-denomination CD's declined. Treasury bill rates, which had risen early in the period--reflecting expectations of a large volume of Treasury debt financing in the bill area--came under sharp downward pressure late in the period, with the three-month bill trading as low as 2.92 per cent. In yesterday's regular Treasury bill auction average rates of about 3.07 and 3.54 per cent were established for three- and six-month bills--down 4 and up 18 basis points, respectively, from rates established in the auction just prior to the January Committee meeting.

In contrast, rates on intermediate- and longer-term securities rose on balance over the period, primarily reflecting the market's concern over the budget deficit but also reflecting a large amount of actual debt financing during the period. Late in the period, however, a better tone emerged in the longer-term markets as the unusually steep yield curve encouraged some investors to extend maturities--a move that had appeared about to get under way just before the news of the budget deficit set the markets back. Chairman Burns' statement to the Joint Economic Committee on February 9 also was a factor helping to restore confidence to the market. Whether or not the better tone in the capital markets is solidly based, however, remains to be seen. While investors have large amounts of funds to put to work, there will be heavy demands on the capital markets from the Government sector. The status of private credit demands and of inflationary expectations as the economy develops under Phase II of the Administration's program undoubtedly holds the key to the future of long-term interest rates.

The Treasury's February refunding operations turned out to be quite successful, including the achievement of a substantial amount of debt extension--much more, in fact, than the market had anticipated. The market generally regarded the Treasury's offerings as generously priced, and although some Treasury support of the 6-3/8 per cent, 10-year bond was required in the middle of the subscription period, both new issues have generally traded at substantial premiums. The public turn-in of $1.6 billion for the ten-year bond was a resounding reaffirmation of the usefulness of the advance refunding technique as a means of extending debt without undue market disturbance--and the Treasury should be commended for its willingness to move ahead to redevelop a market for longer-term Treasury issues.

Looking ahead, the Treasury will have a large amount of cash to raise by June 30--although the precise amount is hard to estimate because of uncertainties about the size of the budget deficit that will in fact be realized. In addition to the weekly increases of $300 million in the regular Treasury bill auctions, a cash financing of $2 to $2-1/2 billion for payment in early March appears necessary, and this could take the form of an auction of a short-term note if the market appears receptive, as it now does. The likely short-term nature of the financing and the use of the auction technique should minimize even-keel implications for the System, although Treasury financing problems will obviously be a factor that the System will have to contend with for some time to come.

As far as open market operations are concerned, the System provided a large amount of reserves early and again late in the period through repurchase agreements to meet what appeared to be temporary reserve needs. Apart from making RP's, the System was in the market on only three occasions, purchasing about $200 million of Treasury coupon issues and about $150 million of Federal agency issues and selling $200 million of short-term Treasury bills. The System also sold nearly $100 million of Treasury bills to foreign accounts and it redeemed $267 million of Treasury bills and Federal agency securities at maturity. Incidentally, in our go-around of the market to buy agency securities last Thursday, we added the securities of another agency--the Farmers' Home Administration--to the list of those eligible for purchase. Those issues were originally excluded because of the lack of active secondary markets, but on further study we reached the conclusion that they are now traded actively enough to make a marginal contribution to our operations in agency securities.

I should also report to the Committee a rather unusual transaction with the International Monetary Fund that we will be undertaking today. By joint agreement with the Treasury, the IMF is repurchasing $400 million in gold from the Treasury, representing the reversal of a sale of gold to the Treasury in the late 1950's. In order to raise funds to buy the gold the IMF is liquidating its portfolio of $400 million-odd Treasury bills

> that it has been carrying in a special account. Simultaneously, the Treasury will redeem $400 million of gold certificates held by the Federal Reserve--an action that will absorb a corresponding amount of reserves from the banking system. To offset this reserve drain, we will purchase Treasury bills directly from the IMF, at market rates. In effect, the System will be replacing in its portfolio non-interest earning gold certificates with interest-bearing Government securities.
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> Looking ahead, it appears that the seasonal decline in required reserves plus the movement of other factors affecting reserves will require the System to absorb reserves on balance over the period before the Committee meets again. A further addition to reserves could come about if the cash drain on the Treasury in early March requires it to draw down its balances at Reserve Banks from the unusually high levels recently prevailing. In addition, passage of the gold revaluation act will create something in excess of $800 million in free gold which the Treasury presumably will want to monetize--creating a corresponding amount of reserves for the banking system. Thus, there may be little net reserve need for System purchases of Government and agency securities for some time to come.

Mr. Daane asked whether it would be feasible for the Desk to undertake some form of operation twist at this time if the Committee concluded that such an operation would be useful.

Mr. Holmes replied that during the coming period the Desk would be selling bills on balance to absorb reserves and, as he had indicated, the Treasury probably would be raising cash by auctioning short-term securities. Both operations would put upward pressure on short-term interest rates. If the Committee so wished, the Desk could sell additional bills to make room for the purchase of longer-term Treasury securities. However, he saw no immediate need for such action, since conditions in long-term markets were quite good at the moment.

Mr. Mayo commented that long-term markets might come under renewed pressure later in the period before the Committee's next meeting. He asked whether the Manager thought he had the authority to undertake concurrent sales of bills and purchases of coupon issues if that appeared desirable, or whether he needed instructions from the Committee on the matter.

Mr. Holmes replied that it would be helpful to have such instructions. In the normal course of events the Desk operated on only one side of the market, depending on whether the need was to supply or absorb reserves.

Mr. Daane said the Committee might well want to issue such instructions if it were concerned about the risk that upward pressures on short-term rates would be transmitted to long-term markets.

Mr. Axilrod noted that the Board staff's projections indicated that there would be a need to supply reserves in the latter part of the coming period if the Treasury did not monetize gold or draw down its balances at the Reserve Banks.

Mr. Robertson referred to the Manager's observation that an overshoot in January reserve growth had appeared desirable because of the continued sluggish performance of M_1. He understood Mr. Holmes' reasoning, but if he had been conducting operations he would not have given so much weight to M_1.

Chairman Burns observed that the overshoot had in fact not been very large.

Mr. Robertson said he was not disturbed by the size of the miss in itself; indeed, he thought the Manager would not necessarily have been subject to criticism if the overshoot had been 5 percentage points greater. He simply wanted to record his own judgment that too much weight had been placed on the weakness of M_1 in the recent period. No doubt other members would have different judgments.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 11 through February 14, 1972, were approved, ratified, and confirmed.

Mr. Axilrod then made the following statement on the monetary relationships discussed in the blue book[1/]:

The blue book presents three patterns of what the staff believes to be mutually consistent relationships among various monetary aggregates and interest rates over the next few months. Each involves a greater rate of expansion in M_1 than in the past two months, and a somewhat slower growth in M_2 and the credit proxy. This change in the behavior of the mix of monetary aggregates is expected for a number of reasons.

First, we believe that the demand for M_1-type cash balances will increase even at rising short-term interest rates over the near-term because of enhanced transactions demands from the accelerated nominal GNP growth that is

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

projected and because of the lagged effect of the substantial declines in short-term rates of recent months.

Second, it seems unlikely that the exceptional 21 per cent average annual rate of growth in time deposits other than large CD's for December-January combined will persist for much longer. During the past four years, only in the first quarter of 1971--when short-term rates had dropped to about current levels--had growth been so large. But banks were more eager to have such funds then, partly to help replace rapidly declining Euro-dollar borrowings. At the present time, with business loan demand continuing to be weak, large banks appear to be reducing offering rates on time and savings deposits. This should begin to moderate the rate of inflow, and help restrain expansion in M_2.

Third, U.S. Government deposits are expected to drop sharply--by \$2-3/4 billion--from January to February, and to regain a modest part of that loss in March. To some extent this swing in U.S. Government deposits is expected to affect the monthly pattern of M_1 behavior. But for the most part it influences bank credit, contributing to the quite small increase expected in February. A substantial rise in bank credit is expected in March, as the drag of declining U.S. Government deposits is eliminated and as banks purchase part of the perhaps \$3-1/2 billion of new cash expected to be raised in the course of that month mainly through Treasury bills. For the months of February and March combined, the staff expects bank credit to expand at a 6-1/2 to 8 per cent annual rate, as compared with an average growth rate of 11-1/2 per cent in the previous two months.

This assessment of bank, public, and Treasury behavior suggests that the Committee might reasonably be able to achieve a target, insofar as it involves the aggregates, which encompasses a significantly higher rate of growth in M_1 than recently and at the same time slows the growth in other aggregates from recent exceptionally rapid rates. It would seem reasonable, though, given the present uncertain state of the economy, to link such a target for the aggregates with an effort to keep long-term interest rates from rising significantly further, at least over the next few months--and when it seems feasible, to encourage declines. Such an approach might not be inconsistent with some little rise in short-term rates, which taken as a group are quite low relative to long-term rates. And within the short-term rate structure, the

3-month Treasury bill rate is, it should be noted, quite low relative to rates on longer-maturity bills.

The spread of long- over short-term rates has in the past narrowed naturally in the course of cyclical economic recovery in reflection of the greater volatility of short-term rates. Over the next two months short-term rates may come under some upward pressure once the Treasury begins to meet its cash requirements. In addition, System policy toward the aggregates could, depending on the growth rates selected, also exert upward pressure on short-term rates. For instance, in the staff's view the aggregate targets shown in pattern III in the blue book seem likely to entail sizable short-term rate increases, assuming a substantial economic recovery of the dimensions shown in the green book. Under pattern II, given substantial economic recovery, a more modest interest rate increase seems likely to develop, with some odds that rates might rise very little, if at all, over the near term.

In balancing its various intermediate monetary objectives, the Committee may wish to consider a target for the aggregates which reduces the likelihood of very sizable short-term rate increases in order to minimize feedback effects on long-term rates and also which keeps growth in the aggregates to proportions that are not likely to have inflationary consequences. Something like pattern II might fill that bill. In addition, though, the Committee might consider the desirability of having the Desk emphasize purchases of longer-term Treasury coupon and Federal agency issues at times when it is providing reserves. Buying opportunities are likely to be fairly limited, however, between now and the next meeting of the Committee since a good part of the reserves to support private deposit growth will be supplied by reserves released from declining U.S. Government deposits.

The Committee had a full discussion yesterday of whether day-to-day operations should be guided more by reserves than by money market conditions. Abstracting from swings in U.S. Government and interbank deposits, it appears that total reserves against private deposits in February and March combined would need to grow at about

> an 8 per cent annual rate, and nonborrowed reserves at about a 9 per cent rate, to support aggregate targets such as in pattern II. Total and nonborrowed reserves against all deposits would at the same time be likely to show little net change, although they will be influenced by the actual behavior of U.S. Government deposits and any adjustments to the reserve target that might be required by very significant deviations from desired behavior in aggregates of more central concern to the Committee.
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> In complementing any reserve flows target with a money market conditions proviso, the Committee might wish to consider a Federal funds rate range somewhat wider than recent experience. A range of 1-1/4 percentage points might be utilized; this could be taken under current conditions as a 2-3/4 to 4 per cent range. The Committee might wish to consider instructing the Manager to be mindful of prospective actual and psychological effects on longer-term credit markets in judging how freely he permits rates to move through this range.

Mr. Heflin asked what reserve target the Desk would be pursuing if the Committee adopted pattern II.

Mr. Axilrod replied that for February and March combined pattern II involved a growth rate of about 8 per cent in reserves available for private nonbank deposits--that is, total reserves less reserves against interbank and Government deposits. For February alone the rate was 5-1/2 per cent and for March it was 10 per cent.

Mr. Daane asked whether the target should not be specified in terms of a range rather than a specific growth rate.

Mr. Axilrod said he assumed the Committee would want to specify a range, both because it probably would not have any narrowly defined target in mind and because it would want to allow for errors of estimate. He had mentioned specific figures only for ease of communication, and would suggest that those figures be considered as the midpoints of ranges.

Chairman Burns said it might be worth noting that the pattern II growth rates for total reserves--without exclusion of reserves against interbank and Government deposits--were minus 5 per cent for February and plus 1 per cent for March--or minus for the two months together.

Mr. Mitchell observed that there was no doubt in his mind that adjustments should be made for reserves against Government deposits since such deposits were highly volatile. It was his impression, however, that interbank deposits were relatively stable, although he had not examined figures for very short periods.

Mr. Axilrod said that in the judgment of the staff interbank deposits were sufficiently volatile in the short run to warrant an adjustment for them also.

Mr. Maisel expressed a similar opinion.

Mr. Daane referred to the Manager's earlier comment that the absence of operational problems under the total reserves target used in January had been fortuitous to some extent. He asked whether the type of reserve target now being discussed was likely to involve fewer problems.

Mr. Holmes replied that some important problems remained to be resolved, including that of developing the seasonally unadjusted reserve figures needed for actual operations. The staffs at the Board and the New York Bank would be working together on such matters. He hoped the Committee would be patient while the necessary experience was gained.

Mr. Axilrod concurred in Mr. Holmes' comment, adding that there no doubt would be some slippage between targets and results. He noted that seasonally unadjusted reserve figures had been developed for use in connection with operations since the January meeting.

Mr. Daane asked what the pattern II target would be on a seasonally unadjusted basis.

Mr. Axilrod said he did not have the figures at hand but could make them available later.

A discussion ensued of the purposes for which the Committee might require information on reserve targets in seasonally unadjusted form. At the end of the discussion there was general agreement that the unadjusted reserve figures should be made available to the Committee members for their use apart from the meeting.

Mr. Mitchell noted that the staff's projections implied a step-up in the rate of growth of demand deposits and a slowing in time deposits. Since reserve requirements were higher for the former, any particular growth rate in reserves would support less expansion in total deposits and bank credit than it would in the absence of the expected change in deposit mix. On the whole, he thought the 8 per cent growth rate of pattern II would be a rather conservative prescription.

Mr. Swan said he had no quarrel with the relationships among the growth rates for the various aggregates--reserves, M_1, M_2, and bank credit--shown under each of the three patterns in the blue book. He noted however, that there were relatively large differences among the money market conditions associated with those patterns. The range shown for the Federal funds rate, for example, was 2 to 3 per cent under pattern I, 3 to 4 per cent under pattern II, and 4 to 5 per cent under pattern III. He would have thought that such dissimilar funds rates would have been associated with larger differences in aggregate growth rates than those shown.

Mr. Daane expressed a similar view. He noted that the first-quarter growth rates shown for M_1 were 7-1/2, 7, and 6 per cent for patterns I, II, and III, respectively. To his mind, differences of one or two full percentage points in the funds rate were not necessarily associated with the projected M_1 spreads and certainly not with a spread of no more than 1/2 point in the M_1 growth rates.

Mr. Maisel remarked that the blue book relationships seemed quite reasonable to him. Because of lags in the system, it was necessary to change money market conditions sharply to produce a substantial response in the aggregates in the short run.

Mr. Axilrod noted that the blue book patterns were based on historical relationships, both as embodied in the money market model the staff employed and as observed judgmentally. For the month of March the M_1 growth rates shown under the three patterns were 8, 7, and 5-1/2 per cent. There were larger differences among the March rates than among those for the first quarter as a whole since the first quarter was, of course, already half over. For the second quarter, the growth rates under the three patterns were 10, 8-1/2, and 7 per cent.

Mr. Francis remarked that like others he had often been puzzled by the relationships shown in the blue book, and he noted that staff projections had sometimes not worked out well. He thought it would be helpful if the staff members responsible for projections would meet with other System personnel for a discussion of the methods they employed.

Mr. Partee noted that a description of the Board's money market model had been distributed to the Reserve Banks and discussed in System meetings. He agreed, however, that a detailed discussion of projection methods employed at the Board and the New York Bank would be helpful.

Chairman Burns asked Mr. Partee to make arrangements for a meeting on that subject.

The Chairman then noted that copies of the testimony he had given before the Joint Economic Committee had been supplied to the Board members and Reserve Bank Presidents. In the course of that testimony he had made a commitment regarding monetary policy on behalf of the Board, and he hoped the full Committee would concur in his statement. The relevant passage from his testimony read as follows:

> Let me turn now to the role that monetary policy needs to play in furthering national objectives this year. Clearly, our monetary affairs--no less than our fiscal affairs--must be kept in order, so that public confidence in our monetary management is maintained. An unduly expansive monetary policy would be most unfortunate, particularly in view of the large Federal budgetary deficits now projected. We need always to be mindful of the fact that increases in money and credit achieved today will still be with us tomorrow, when economic conditions may no longer be the same as they are today.
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> At this stage of the business cycle it is essential to pursue a monetary policy that will facilitate good economic recovery. Supplies of money and credit must be sufficient to finance the growth in consumer spending and in investment plans that now appears in process. Let me assure this Committee that the Federal Reserve does not intend to let the present recovery falter for want of money or credit. And let me add, just as firmly, that the Federal Reserve will not release the forces of a renewed inflationary spiral.
>
> We are now in a favorable position to provide the monetary support needed for a quickening pace of production and employment. While expansion in the supply of money and credit was relatively brisk during 1971, we successfully avoided an unduly rapid growth in liquidity.

Chairman Burns then suggested that the Committee turn to a discussion of monetary policy. He observed that at the conclusion of its meeting yesterday the Committee had agreed on the workability of language for the second paragraph of the directive similar to that shown in alternative A of the staff's drafts,[1/]

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

and on a procedure he had proposed for formulating guidance to the Manager in implementing such language. For the members' convenience, copies of a statement of that procedure, as he had outlined it yesterday, had been distributed.[1] Accordingly, he thought the Committee could focus today on the question of specific targets.

Mr. Robertson said he had not come away from yesterday's meeting with the impression that the Committee had agreed to adopt alternative A for the directive.

Chairman Burns recalled that in summarizing the Committee's discussion yesterday he had noted that there were strong differences of view regarding the relative emphasis to be placed on reserves and money market conditions as the handle for operations. He had suggested, therefore, that the Committee continue to use directives like those it had adopted in December and January, which avoided special emphasis on either kind of handle. Alternative A of the staff's drafts was such a directive. While he had thought the Committee had accepted that suggestion, the question of the relative merits of alternatives A and B could, of course, be reopened if the members so desired.

Mr. Mitchell said he had questions both about the directive and about point 4 of the summary of the procedure for giving guidance to the Manager. He would prefer to limit the second paragraph

1/ A copy of the document referred to is appended to this memorandum as Attachment C.

of the directive to an instruction formulated in terms of reserves, with a qualification regarding the acceptable range of fluctuation in money market conditions. Contrary to point 4 of the summary, the Manager would not be instructed to make allowance in his operations for undesired movements in the monetary aggregates. The Committee's preferences with respect to the aggregates--and also interest rates--would be treated as intermediate objectives and set forth in the first paragraph of the directive. If movements in those variables were not consistent with the Committee's desires, it would be the Committee's task at the next meeting to consider whether some change should be made in its instructions concerning reserves and money market conditions.

Chairman Burns remarked that he personally might have preferred to follow a procedure like the one Mr. Mitchell had outlined. However, he had concluded from yesterday's discussion that a majority of the Committee favored having the Desk make some allowance for the behavior of the monetary aggregates in the course of its operations. Accordingly, he had included point 4 in his summary.

The Chairman then said it might help clarify the implications of the various parts of that summary if he were to describe some specific objectives the Committee might associate with each of the points covered. While the specifications he would mention were not hypothetical--indeed, they had been carefully considered--

his purpose in setting them forth now was mainly to illustrate how the procedure would work in practice. Under point 1 the Committee might instruct the Desk to aim for a seasonally adjusted annual rate of growth in reserves for private nonbank deposits--that is, total deposits less U.S. Government and interbank deposits--in a range of 6 to 10 per cent in the months of February and March combined. Under point 2, the acceptable range for fluctuations in the Federal funds rate might be defined as 2-3/4 to 3-3/4 per cent. Point 3--that the Federal funds rate should be moved in an orderly way--required no further comment. For purposes of point 4, the desired growth rates for the monetary aggregates might be specified in terms of the following rates for the first quarter: 7 to 8 per cent for M_1, approximately 12 per cent for M_2, and 8 to 9 per cent for the bank credit proxy. Such figures could, of course, be readily translated into desired rates for February and March by making allowance for the growth already recorded in January.

The fifth point, the Chairman continued, was very important. It read as follows: "If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is to notify the Chairman who will consider whether the situation calls for special Committee action to give supplementary instructions." In effect, if the Manager found his package of instructions to be unworkable, he would notify the Chairman promptly; and if the Chairman agreed, he would communicate promptly with the Committee which would then have to decide on its course of action.

Mr. Maisel said he thought the five-point summary that had been distributed was consistent with the understanding the Committee had reached at the end of the meeting yesterday. As he interpreted that understanding, reserves were to be used as an operating handle, as indicated in point 1, but there also were to be provisos relating to money market conditions and monetary aggregates, as reflected in points 2 and 4. The remaining points--3 and 5--represented supplementary instructions.

While he considered the summary accurate, Mr. Maisel continued, he had not thought that a majority of the members had expressed a preference for a directive along the lines of alternative A. Rather, it had seemed to him that of those indicating a preference the majority were in favor of the type of language shown under alternative B.

Mr. Brimmer remarked that he also had thought there was more sentiment for alternative B than for A. With respect to the five-point summary, he was rather troubled by the indefiniteness of the last point. For one thing, it was not clear to him how the Manager would decide whether the Committee's objectives and constraints were being met "satisfactorily."

Chairman Burns said it was important to remember that the Committee's task was to develop policy, not to implement it. He thought, however, that the final clause of point 5 could be clarified. He would suggest revising it to read, "...the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions."

Mr. Brimmer agreed that that change would be helpful. He still was unsure, however, whether or not the supplementary instructions would be formulated at a meeting of the Committee. He had been disturbed by the fact that it had been necessary for the Committee members to provide supplementary instructions outside of meetings in both December and January. It would be desirable, he thought, to minimize the number of such situations.

Mr. Sheehan asked the Manager to describe the kinds of circumstances which would lead him to notify the Chairman that the Committee's various objectives were not being met "satisfactorily."

Mr. Holmes replied that he might illustrate such circumstances by reference to objectives for the monetary aggregates. He would be watching developments with respect to M_1, M_2, and the bank credit proxy from day to day as he attempted to meet the specifications for reserves and money market conditions the Committee had decided upon, and he would expect to notify the Chairman if the growth rates in all of those aggregates were, say, above the desired ranges by 2 percentage points or so. His problem would be more difficult if the deviations for different aggregates were in opposite directions. While he would have to exercise judgment in such cases, he assumed that the Committee members would also be following developments as the period progressed and would be prepared to make their own judgments.

Chairman Burns remarked that Mr. Holmes' concluding comment was a useful one. He (the Chairman) would appreciate hearing from any member who thought that the Committee's objectives and constraints were not being met satisfactorily. He personally planned to keep informed of ongoing developments and would not necessarily wait for word from Mr. Holmes.

Mr. Heflin referred to Mr. Maisel's comment regarding the Committee's directive preferences and said his own understanding differed from Mr. Maisel's. He thought it had been agreed yesterday that a directive like alternative A would prove serviceable at least for the next few months.

Messrs. Hayes, Daane, Coldwell, and MacLaury expressed a similar view. Mr. MacLaury added that he did not concur in Mr. Maisel's statement that the instructions regarding money market conditions were simply a proviso attached to a reserve handle. As he had understood the Committee's consensus, the Manager was to consider both types of variables concurrently, giving them equal weight.

Chairman Burns agreed that the variables should be considered concurrently, but he did not think a question of weights to be assigned arose. If the Manager found that he could not achieve the Committee's objectives for both variables he was to inform the Chairman promptly, and the latter would decide whether to call a telephone conference or a Washington meeting of the Committee. As to the differences of view regarding the members' preferences between alternatives A and B for the directive, the issue could be resolved simply by polling the group.

Mr. Robertson observed that it was he who had first expressed doubt that the Committee had agreed yesterday to employ alternative A. He would note, however, that the choice between A and B did not strike him as a matter of great importance, since each referred to both money market conditions and reserves. The main difference was that money market conditions were referred to in the main instruction in A but in a proviso clause in B. In his judgment either formulation could be used to convey the kind of instructions the Committee contemplated.

The Chairman asked those who considered the alternative A formulation acceptable, at least for today's directive, to so indicate. Nine members of the Committee, and five Reserve Bank Presidents not currently serving, responded affirmatively.

The Chairman then called for the go-around of comments on monetary policy. He suggested that each participant not only indicate his preferences for the specifications to be adopted under points 1, 2, and 4 of the statement regarding the guidance to be given to the Manager, but also comment on the degree of emphasis that should be placed on purchases of coupon issues in the conduct of operations. In addition, it would be helpful to have the views of the Reserve Bank Presidents regarding the desirability of an early change in the discount rate.

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

> The setting for the determination of monetary policy today includes an economy which is beginning to show a bit more strength, some signs of reviving inflationary expectations fueled in part by the discouraging fiscal prospects, and an international situation which remains very uneasy and might even pose the threat of a new currency crisis--although I am hopeful that quick passage of the gold bill will dispel this danger. The massive credit needs of the Treasury--including credit programs outside of the budget--appear likely to place a very heavy burden on the financial markets in the months ahead and beyond, particularly as they will probably be coupled with large and growing demands of private borrowers. In recent months we have witnessed a large decline in short-term interest rates and very liberal growth of the aggregates other than the narrow money supply. Current projections for February and March indicate generous growth rates for all the aggregates, including M_1. The economy and the banks are exceedingly liquid, and if bank loans remain stagnant it is not for lack of reserves.
>
> I have an uneasy feeling that we are about to repeat the errors of early 1971, when excessive concern over shortfalls in M_1 helped bring on the subsequent explosive growth in the aggregates. Recognizing the substantial

lags that probably apply to the link between money market conditions and growth of the narrow money supply, we should be careful not to overstay our policy of aggressive monetary ease of recent months.

My policy prescription today would be, at a minimum, not to move further in the direction of easier money market conditions. In fact if, as seems quite possible, market forces should begin to put upward pressures on short-term interest rates, I would allow this to take place within modest limits. If the Committee wishes to specify a range for the Federal funds rate, my preference would be for a range of, say, 3-1/4 to 3-3/4 percent, with free reserves of perhaps $150 million, and minimal borrowings as long as the funds rate is below the discount rate. There are so many uncertainties surrounding the bill market, due in part to foreign official transactions, that it would appear futile to stipulate any range for this rate.

As for the directive, I would like to see a return to use of the word "moderate" for desired growth of the money and credit aggregates (and I would include credit as well as money), with emphasis also on money market conditions conducive to moderate growth. Even though, as I indicated yesterday, my preference is for a money market conditions directive, I could go along with alternative A, with general specifications close to those of pattern II. Although the range indicated for the Federal funds rate under that pattern--3 to 4 per cent--is rather wide, it would be acceptable to me. I would think that a 7 per cent growth rate for M_1 for the first quarter could still be described as "moderate." We can make a judgment later on about appropriate growth rates for the second quarter. I think it would be helpful to make somewhat greater use of operations in coupon issues.

With respect to the discount rate, this is a time, it seems to me, when we should especially avoid any more or less automatic adjustment to recent market rate declines. As I have already indicated, these declines seem to me to have gone a bit further than underlying conditions would warrant; upward pressures may well appear in the coming months and we may well be faced with the necessity, a few months from now, of increasing the discount rate. Under these conditions I see no merit in compounding any future difficulties with the discount rate by cutting the rate at this time.

Mr. Francis remarked that while alternative A for the directive was acceptable to him he would prefer alternative B. Of the three sets of growth rates in the aggregates shown in the blue book, he preferred the pattern III rates, described as "moderate," although even those rates might prove to be a bit excessive. As he had indicated in yesterday's discussion he favored using reserves as the handle for operations. He also concurred in the view that the Desk should keep close watch on the growth rates of the monetary aggregates, and that it should adjust its reserve target in the latter part of the period before the next meeting if the growth rates of the aggregates differed from those the Committee desired. He had no strong feelings regarding the desirability of operations in coupon issues at this time.

Mr. Francis said he adhered to the view that it was a good policy to keep the discount rate reasonably in line with market interest rates. Since the discount rate was far out of line with the market he thought it should be lowered now. It could be raised again in a month or two if market rates moved up.

Mr. Kimbrel said the growth rates for M_1 shown under pattern III in the blue book accorded fairly well with his idea of "moderate" growth, although he would be happier with a first-quarter rate of 5 to 6 per cent than with the 6.5 per cent rate shown. Also, he was disturbed by the indication in the blue book that the 6.5 per cent rate would be achieved only if M_1 grew at a comparatively low pace in March, offsetting the rapid growth expected in February. Considering the imprecisions of projections, it was quite possible that growth in March would not be as slow as indicated. He hoped, therefore, that the Desk would not be too cautious in allowing money market rates to rise if an increase appeared necessary to prevent a deviation of reserves from the target for them. Of course, he would not favor a rise in rates unless needed to implement policy. He thought it would be desirable, when feasible, to engage in purchases of coupon issues in the hope of having some favorable influence on long-term interest rates.

As to the discount rate, Mr. Kimbrel continued, he certainly did not consider this to be an appropriate time for a reduction. In his judgment, that time had passed; a reduction now was likely to be incorrectly interpreted by the market as a further move toward ease. Moreover, he thought it might prove difficult to raise the discount rate later if market rates moved up.

Mr. Eastburn said he found a disturbing parallel between the logic employed a year ago and the argument being made today that, unless the aggregates were permitted to grow at an ample pace, short-term interest rates would rise and that in turn would put upward pressure on long-term rates. The difficulty with such logic was that it could lead, after a quarter or two, to circumstances in which unacceptably large increases in interest rates would be required to slow the growth in the aggregates to a reasonable pace. It was better, he thought, to act before such circumstances developed.

Secondly, Mr. Eastburn continued, he was skeptical that a moderate rate of growth in M_1 would be associated with as much upward pressure on interest rates as the staff suggested. In that connection, he noted that one of the findings in the Philadelphia Bank's recent national survey of corporate treasurers was that there was now less concern than earlier that long-term rates would rise significantly in the near future.

While he favored a moderate growth path for M_1, Mr. Eastburn observed, he would be reluctant to see the Federal funds rate rise as much as was specified under pattern III. If it developed that a funds rate above a 3-1/4 to 4-1/4 per cent range was required to hold growth in the aggregates down to the pattern III rates he would be willing to accept the growth rates of pattern II. He favored operating in coupon issues to the extent feasible.

With respect to the discount rate, Mr. Eastburn said he was a strong believer in flexibility. However, he would not be inclined to reduce the discount rate now if it appeared that short-term interest rates would be rising, as might well be the case if the Committee decided to aim for the pattern III growth rates in the aggregates.

Mr. Winn remarked that he shared Mr. Eastburn's skepticism about the consistency of the pattern III specifications for growth rates in the aggregates and interest rates. In any case, he would like to see the aggregates grow at a moderate pace, provided that interest rates did not rise as sharply as indicated. He would be happy to have the Desk operate in coupon issues if conditions permitted.

Mr. Winn added that because the discount rate had been out of touch with market rates for some time a reduction now was likely to be misinterpreted. Accordingly, he would not favor lowering the rate.

Mr. Sheehan said his views on policy had not changed much since the January meeting of the Committee. On the whole, he thought prevailing expectations regarding the economic outlook were a little more hopeful than warranted by the facts available to date. Today's meeting date was midway through the first quarter, and if the recovery did not strengthen this quarter he doubted that it would do so later in the year.

Accordingly, Mr. Sheehan observed, he leaned toward greater ease. He would not want to go as far as called for under pattern I, but he would move in that direction.

Mr. Brimmer observed that the growth rates of the aggregates shown under pattern II were of about the right order of magnitude and he favored adopting the specifications of that pattern. He would add, however, that for international reasons he was concerned about the present level of short-term interest rates, particularly Treasury bill rates. He hoped the three-month bill rate would not be below the lower limit of the 3 to 4-1/2 per cent range shown under pattern II for any extended period; indeed, he would like to see short-term rates move up somewhat from their present levels. He would be agreeable to purchases of coupon issues if opportunities for them arose and if the Manager thought they would be helpful in attaining Committee objectives.

Mr. Brimmer expressed the view that the proposed instructions to the Manager, including the alternative A directive language, were rather loose. However, since the Committee had debated the matter earlier, he would not pursue it at this point.

Mr. Maisel recalled that at other recent meetings he had argued that growth in the monetary aggregates at about the rates now shown under pattern II would be required if the economy was going to expand in 1972 at the pace the staff was then projecting. Now that the staff had lowered its GNP projections one might argue that higher growth rates, such as those shown under pattern I, were required. On balance, however, he still favored the pattern II rates. The specifications the Chairman had listed earlier also were acceptable to him.

Mr. Daane said he was unhappy about the recent sluggishness of industrial production and the continuing high level of unemployment, no matter how those figures might be rationalized. Nor was he as convinced as some that consumer and business confidence would improve sharply. Finally, he was very much concerned about the developing view abroad that the United States was adopting a posture of benign neglect.

Mr. Daane remarked that he would be prepared to accept the growth rates in reserves and the monetary aggregates shown under either pattern II or III. He did not place credence in projections involving such small differences, and he doubted that the choice would have significant consequences for the Manager's operations. His view that aggregate targets need not be specified precisely was embodied in the Chairman's suggestion that the Committee adopt a 6 to 10 per cent target for growth in private nonbank reserves in February and March. Alternative A seemed to him to represent a reasonable compromise for the directive. However, instead of describing the desired growth in the aggregates as "ample" or "moderate"--the terms the staff proposed in connection with patterns II and III--he would employ the adjective "sufficient."

With respect to interest rates, Mr. Daane said, he preferred the specifications of pattern II to those of III. He hoped the Committee would not focus exclusively on the Federal funds rate;

like Messrs. Hayes and Brimmer, he would want to avoid further declines in Treasury bill rates and perhaps have them move a little higher--although not too much higher. Also, he thought the Manager should be alert to any signs that upward pressures on short-term rates were being transmitted to long-term markets. In that connection, he would favor increased emphasis on purchases of coupon issues if the Manager found them feasible at times when he was supplying reserves. The System should do whatever it could to counter a spill-over of rate pressures into long-term markets.

While the Chairman had directed his request for comment on discount rates to the Reserve Banks Presidents, Mr. Daane continued, he would like to express his own trepidation that a reduction in the discount rate now would reinforce the feelings abroad that the U.S. posture was one of benign neglect. In the absence of some compelling reason to reduce the discount rate--and he was aware of none at the moment--he would not favor such action.

Mr. Mitchell remarked that within the confines of the proposed directive--which, as he had indicated earlier, he did not like--he would prefer specifications between those of patterns I and II. If the Committee adopted pattern III he would find it necessary to dissent. Even pattern II struck him as being rather close to the margin of acceptability.

In his judgment, Mr. Mitchell continued, it was highly important for the Committee to achieve lower long-term interest rates, and he would favor any contribution to that end that might be made by purchasing coupon issues. Indeed, he thought the Committee should make a reduction in long-term rates one of its goals. As to the target for growth in private nonbank reserves in February and March, he would favor aiming somewhat above the 6 to 10 per cent range the Chairman had suggested--perhaps at a range of 8 to 12 per cent. In short, he advocated a somewhat easier policy than most of those who had spoken thus far.

Mr. Heflin said he favored the specifications of pattern II. He noted that the range for the Federal funds rate indicated under that pattern was 3 to 4 per cent, whereas in the specifications the Chairman had suggested earlier the range was 2-3/4 to 3-3/4 per cent. While he was not sure how much significance should be attached to the quarter-point difference, he would be inclined to hold the funds rate at 3 per cent or above so long as the outcome was of a nature that would satisfy the commitment the Chairman had made in his JEC testimony. What concerned him was the risk that heavy Treasury borrowing, a large calendar of municipal offerings, and growing business loan demand would combine in the months ahead to produce a situation in which overly rapid expansion in M_1 was coupled with a sharp upturn in interest rates. He thought the Committee should be prepared to let the funds rate move up as and when market pressures developed.

Mr. Heflin observed that he had no strong views on the subject of purchases of coupon issues. He suspected, however, that one of the causes of upward pressure on long-term interest rates was the persistence of inflationary expectations, reflecting a lack of confidence in the effectiveness of the price and wage boards. He agreed with Messrs. Eastburn, Winn, and others that this would be a bad time to change the discount rate.

Mr. Clay said he preferred the specifications of pattern II. The specifications the Chairman had suggested were slightly more expansive, but they were sufficiently close to those of II to be acceptable also. He doubted that there would be the opportunity in the coming period to accomplish much by purchases of coupon issues, but he certainly would be willing to have such operations carried out to the extent feasible.

Mr. Clay noted that he favored a near-term reduction in the discount rate. He thought domestic misinterpretations could be avoided by making clear in the announcement that the purpose was simply to bring the rate into better alignment with the market. That had been done on past occasions. He doubted that foreign observers were so unsophisticated as to focus on the behavior of the discount rate rather than on that of market rates.

Mr. Mayo observed that while he preferred the specifications of pattern II he also considered those mentioned by the Chairman to be satisfactory. In connection with either set, he would widen the range for the Federal funds rate to 2-3/4 to 4 per cent.

Mr. Mayo said he was concerned about the fact that the discussion so far had focused on objectives for the rest of the first quarter--a period of only six weeks--with little or no attention paid to the second quarter. No doubt that was due in part to a lack of confidence in projections for longer periods. As the directive committee had noted, however, there were good reasons for employing a policy horizon of three to four months.

As to operations in coupon issues, Mr. Mayo continued, decisions about their feasibility at any particular time had to rest on the judgment of the Manager. Obviously, it would be more difficult to find occasions for purchases when the System was absorbing rather than supplying reserves on balance, but he would encourage the Manager to avail himself of any opportunity to buy coupon issues.

In concluding, Mr. Mayo indicated that he would be opposed to a reduction in the discount rate at this point. He thought mistaken interpretations would be placed on a cut in the rate in some quarters abroad, not because foreign observers were unsophisticated but because such interpretations would serve domestic political purposes for some.

Mr. MacLaury remarked that, while he shared Mr. Daane's concern about the economic outlook, he believed the Committee had gone about as far as it could to supply the funds needed to finance recovery at a desirable rate. He agreed with Mr. Eastburn that if the Committee sought to reduce pressures on long-term interest rates it would risk repeating the experience of the second quarter of 1971, when growth in the monetary aggregates had been much faster than any member had wanted. He was not opposed to purchases of coupon issues. He would note, however, that whatever might be accomplished through coupon operations could be undone many times over if the Committee's general policy stance stimulated inflationary expectations.

Mr. MacLaury said he favored the specifications of pattern II. However, he would not be disturbed if the funds rate moved somewhat above 4 per cent and would prefer to specify a range for that rate of 3 to 4-1/4 per cent. With respect to the discount rate, he shared the view of those who thought the time for a reduction had passed. Also, like some others he was concerned about the possibility of misinterpretation abroad.

Mr. Swan said he favored growth in the aggregates in the neighborhood of the rates shown under pattern II, but shaded toward the rates of pattern III rather than I. In other words, he would like to see the aggregates grow at rates slightly lower than those the Chairman had suggested. He thought such growth rates could be achieved within the interest rate ranges shown under pattern II, but he was willing to accept a 2-3/4 to 4 per cent range for the funds rate.

Like Mr. Daane, Mr. Swan continued, he had serious questions about the adjectives the staff had proposed for use in the directive in connection with the three patterns. For example, "greater" growth in the monetary aggregates did not seem appropriate for pattern I, since under that pattern the rate of increase in bank credit was projected to decline from the fourth quarter of 1971 to the first quarter of 1972. Also, the word "ample," proposed in connection with pattern II, struck him as a poor choice since the Committee would not specify any particular growth rates unless it had decided that those rates would be ample under the prevailing circumstances.

With respect to operations in coupon issues, Mr. Swan said he doubted that they would accomplish much, but at the same time he saw no harm in them. As to the discount rate, he thought every consideration argued for a reduction except, perhaps, the international situation. By permitting the rate to remain out of line with the market the System was reducing the credibility of its position that that alignment should be preserved, and the longer it waited before acting the more difficulty it would have later in raising or lowering the rate because of announcement effects. He could be persuaded that the discount rate should not be reduced now on international grounds, but at the moment he thought the balance of considerations argued in favor of a reduction.

Mr. Coldwell commented that the aims of national stabilization policy at present were to stimulate economic recovery, reduce unemployment, stop inflation, and increase resource utilization. The latest economic information had served to dampen the optimism which some had felt earlier, but which he had not shared.

As to monetary policy, Mr. Coldwell continued, its ultimate aims were the same. More specific policy objectives included somewhat lower long-term rates, somewhat higher short-term rates, and greater stability in market conditions and expectations, both domestically and internationally. There were questions, however, as to how much could be accomplished through monetary policy. For example, he had some doubt as to whether easier money could further the economic recovery or reduce long-term rates, and whether it could increase the demand for credit and stimulate production and consumption.

To his mind, Mr. Coldwell said, the balance of considerations called for reduced pressure for reserve additions. Also, he thought Desk strategy should be reoriented to supply reserves through purchases of coupon issues and to absorb reserves through sales of bills and short-dated notes and agency issues. Like Mr. Swan, he would favor the specifications of pattern II shaded toward those of III. He had arrived at that preference largely because he thought the Committee had already set in train sufficient reserves and liquidity to support the projected growth in GNP. He did not favor a further easing of monetary policy because he could not believe that unemployment would be reduced or recovery accelerated by an increased rate of credit provision. Rather, the uncertainties of the market would be accentuated and increased international rate differentials would spur further capital outflows. He was prepared to see some back up in short-term rates and he hoped Desk operations would bring about a decline in long-term rates.

In sum, Mr. Coldwell observed, he was in favor of a continued System posture of supplying ample but not enlarged reserves. He thought a directive along the lines of alternative A, with equal emphasis on money market conditions and reserves, would probably be appropriate for the next several months.

Mr. Coldwell then expressed the view that the Desk had been using repurchase agreements excessively to supply reserves. In his judgment, it should have been relying more on purchases of long-term coupon issues for that purpose. He noted that there also had been problems recently in connection with the rates charged on repurchase agreements.

With respect to operations in agency issues, Mr. Coldwell said he doubted that the Committee had intended them to be confined to purchases, and he suggested that the Desk should sell short-term issues from its portfolio at times when it was absorbing reserves. Also, he thought one could argue that the volume of purchases had been higher than the Committee had contemplated. In his judgment, however, the more important matter was the desirability of operating on both sides of the agency market.

Chairman Burns commented that Mr. Coldwell's observation on that score was a very useful one.

Mr. Coldwell went on to say that he would not favor a reduction in the discount rate at this time, largely because he thought such action would have an undesirable announcement effect. The likelihood that short-term interest rates would be rising in the near future also militated against a cut in the rate now.

Mr. Morris commented that he would be opposed to a further decrease in the discount rate now for the reasons others had mentioned. Also, he thought it would be quite difficult for the System to raise the rate later, so long as Phase II was in effect. It probably would prove desirable to keep the discount rate unchanged throughout the year, and he suspected that the present 4-1/2 per cent rate could be maintained during 1972 without any great problem.

As to operations in coupon issues, Mr. Morris expressed the view that the Manager should have continuing authority to engage in such operations whenever he felt they would help meet the Committee's objectives. However, he would not expect coupon operations to make any substantial contribution to those objectives. In particular, he considered it futile to expect to change the shape of the yield curve sufficiently to have a significant effect on international money flows.

Mr. Morris then said he shared Mr. Mitchell's reservations about point 4 in the Chairman's summary of the guides for operations. He thought it would be a mistake to instruct the Manager to revise the reserve targets during the inter-meeting period if the monetary aggregates were deviating significantly from expectations, partly because the information that would be available for the purpose was not good; reliable estimates of the aggregates were available only with a two-week lag. Secondly, there often would be a problem of divergent behavior among the aggregates--as had been the case in the period since the January meeting, when M_1 fell short of expectations but M_2 and the bank credit proxy had been higher than expected. He noted that under those circumstances the Manager had aimed at a rate of growth in total reserves above the initial target range. If he (Mr. Morris) had been participating in the daily conference call during the period, he would not have supported the proposition that it was appropriate to raise the reserve target simply because M_1 was running below expectations in that brief interval. Third, the instruction to make "some allowance" for deviations in the aggregates from expectations was unclear since the magnitude of the allowance was not defined. If the initial target range for growth in reserves was 6 to 10 per cent, the instruction conceivably could be interpreted to authorize adjustments up to 12 or 15 per cent or down to 3 per cent.

In sum, Mr. Morris remarked, he thought the Committee had reintroduced a substantial element of imprecision in its instructions to the Manager by including point 4. Mr. Holmes would no doubt agree that his judgment and ingenuity would be tested severely even if his instructions were limited to the remaining points.

In concluding, Mr. Morris said the specifications shown under pattern II appeared appropriate. However, those the Chairman had described also would be acceptable to him.

Mr. Robertson said he saw nothing in the economic picture that warranted any significant easing or tightening at this juncture. Consequently, he favored holding steady in the boat.

As he read the proposed directive, Mr. Robertson continued, it called for placing greater emphasis on reserves and less on money market conditions. He agreed with such a course, and he thought the reserve target that the Chairman had suggested would be appropriate for the time being. He was less concerned than some around the table about the risks of wider fluctuations in the Federal funds rate.

Unlike Mr. Morris, Mr. Robertson continued, he approved of the role assigned to the monetary aggregates in the procedure the

Chairman had outlined. Less emphasis would be placed on them than on reserves or money market conditions; in effect, they would be third in the list of considerations the Manager should be taking into account. It was desirable to take some account of the aggregates, however, for the clues they could offer as to whether reserves were being supplied too rapidly or too slowly. By using the aggregates as outside guideposts the Committee should be able to do a better job of meeting the needs of the economy over the longer run than it had in the past. At present, he would not like to provide reserves at such a pace as to cause them to expand at rates faster than indicated under pattern II; rates closer to those of the pattern III would be more to his liking. The ranges specified for the Federal funds rate and the Treasury bill rate under pattern II were acceptable to him.

Chairman Burns said that, before summarizing the members' views on policy, he would note that the Open Market Committee was heavily indebted to Messrs. Maisel, Morris, and Swan, the members of the committee on the directive. In its meetings yesterday and today the FOMC had agreed to move a significant distance in the direction they had recommended, and after experience was gained with the new procedures it might well decide to go further in that direction.

The Chairman then observed that a majority of the members appeared to be agreeable to the specifications he had described earlier, with the possible exception of the 2-3/4 to 3-3/4 per cent range he had proposed for the Federal funds rate. He asked whether the members would prefer the slightly wider range of 2-3/4 to 4 per cent.

Nine members responded affirmatively.

Mr. Hayes suggested that the members be asked to express their preference between that range and the 3 to 4 per cent range shown under pattern II.

In response to that question, seven members indicated that they favored setting the lower limit of the range at 2-3/4 per cent and five expressed a preference for a lower limit of 3 per cent.

The Chairman noted that the Committee had agreed earlier to employ language along the lines of alternative A for the second paragraph of the directive. However, there had been some criticism during the go-around of the adjectives the staff had proposed to describe the desired growth rates in the monetary aggregates. He would suggest that the term "moderate" be employed.

There was general agreement with that suggestion.

Mr. Daane said he had some question about the staff's proposal to delete the clause "while taking account of international developments" from the second paragraph, particularly in view of the current fears abroad that the United States was adopting a posture of benign neglect.

Mr. Maisel remarked that clauses of that kind normally were included in the second paragraph only when the developments cited were considered likely to have important implications for operations. He noted that statements regarding recent international developments were included in the draft of the first paragraph.

Chairman Burns said he was inclined to agree with Mr. Daane. Retaining the clause was unlikely to do any harm, whereas if it were deleted observers might draw mistaken inferences when the directive was published in three months.

Turning to the matter of operations in coupon issues, the Chairman said he personally shared Mr. Morris' view that such operations were not likely to accomplish much. There seemed to be general agreement, however, that the Desk should give some emphasis to coupon operations. Although the System apparently would not be supplying reserves on balance in the coming period, perhaps the Manager should be instructed to take advantage of opportunities that might arise to sell off some modest amount of bills for the purpose of making room for purchases of coupon issues.

Mr. Robertson said operations of that kind might be appropriate if they were intended for the specific purpose of reducing long-term rates. As a general rule, however, he thought it was desirable to avoid such operations, since the System could easily find itself in the position of making markets.

Chairman Burns commented that the purpose he had in mind was to nudge long-term rates down.

Mr. Holmes observed that instead of selling bills and buying coupon issues at about the same time, the Desk might make some room for purchases of coupon issues by letting maturing bills run off.

Mr. Brimmer remarked that he was disturbed by the Chairman's use of the term "nudge" since in the past "operation nudge" had often been employed as a synonym for "operation twist." He would be opposed to undertaking a new operation twist without full discussion by the Committee. He had had much more modest objectives in mind when he had indicated earlier that he would not object to purchases of coupon issues if opportunities for them arose and the Manager thought they would be helpful.

Chairman Burns asked whether there would be any objections to proceeding on the more modest basis Mr. Brimmer had suggested, and none was raised.

The Chairman then proposed that the Committee vote on a directive consisting of the staff's draft for the first paragraph and alternative A for the second paragraph with the clause "while taking account of international developments" restored and the adjective "moderate" used to describe the growth in monetary aggregates desired over the months ahead. It would be understood that in implementing that directive the Manager would be guided by the specifications agreed upon earlier under the five-point procedure, including a range for the Federal funds rate of 2-3/4 to 4 per cent under point 2.

Mr. Hayes said he would find it necessary to dissent from such a directive for essentially the same reasons he had dissented from the directive adopted at the January 11 meeting. First, he did not favor placing as much emphasis as contemplated on reserves as the operating variable; he would prefer to place main emphasis on money market conditions. Secondly, the specifications that had been agreed upon would permit a degree of ease in money market conditions that he thought would entail substantial risks both domestically and internationally.

> With Mr. Hayes 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 indicates 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. For the current quarter, growth is projected at a rate close to that of the fourth quarter. Prices increased sharply in December, in part reflecting termination of the 90-day freeze. Wage rates also rose substantially in December when some increases that had been deferred under the freeze were allowed to go into effect, but the rise slowed in January. The narrowly defined money stock, which had not grown on balance from August to November, rose somewhat in December and January. Inflows of time and savings funds at bank and nonbank thrift institutions increased sharply in January, and both the broadly defined money stock and the bank credit proxy expanded rapidly. Some short-term interest rates have declined further in recent weeks while yields on long-term securities generally have increased from the lows reached around mid-January. Exchange rates for most major foreign currencies against the dollar have appreciated to levels near or above their new central values. Since the Smithsonian meeting, capital reflows to the United States have somewhat exceeded the underlying U.S. balance of payments deficit. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to 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, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

Chairman Burns then noted that a memorandum from the Manager entitled "Transactions in Government Agency Issues" had been distributed to the Committee on January 25, 1972.[1/] He asked Mr. Holmes to comment.

Mr. Holmes remarked that, as the members would recall, the Committee had agreed that the initial guidelines under which the Desk conducted outright operations in issues of Federal agencies should be subject to review and revision on the basis of operating experience. He planned to submit a broad review of experience to date before the Committee's organization meeting in March. Meanwhile, he would like to recommend a change in one of the guidelines--number 5, which limited purchases to issues outstanding in

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

amounts of $300 million or over for obligations with a maturity of five years or less, and to issues outstanding in amounts of $200 million or over for obligations having a maturity of more than five years.

As the guideline was now formulated, Mr. Holmes continued, the maturity of the issue was determined at time of purchase. Thus, issues outstanding in an amount between $200 million and $300 million would be eligible for purchase so long as they had more than five years of maturity remaining, but when the time arrived at which they had less than five years to maturity they would become ineligible. From a practical standpoint it appeared that once an issue was known to be suitable for purchase, and perhaps was already held in the System Account, it should not lose its eligibility merely because its maturity had shortened. Accordingly, he would recommend that the guideline be revised to specify that the maturity should be determined at time of issuance rather than at time of purchase.

After discussion, the Committee agreed that the change recommended by Mr. Holmes was desirable.

> By unanimous vote, guideline 5 for the conduct of System operations in Federal agency issues was amended to read as follows:

> Purchases will be limited to fully taxable issues for which there is an active secondary market. Purchases will also be limited to issues outstanding in amounts of $300 million or over in cases where the

obligations have a maturity of five years or less at the time of issuance, and to issues outstanding in amounts of $200 million or over in cases where the securities have a maturity of more than five years at the time of issuance.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, March 21, 1972, at 9:30 a.m.

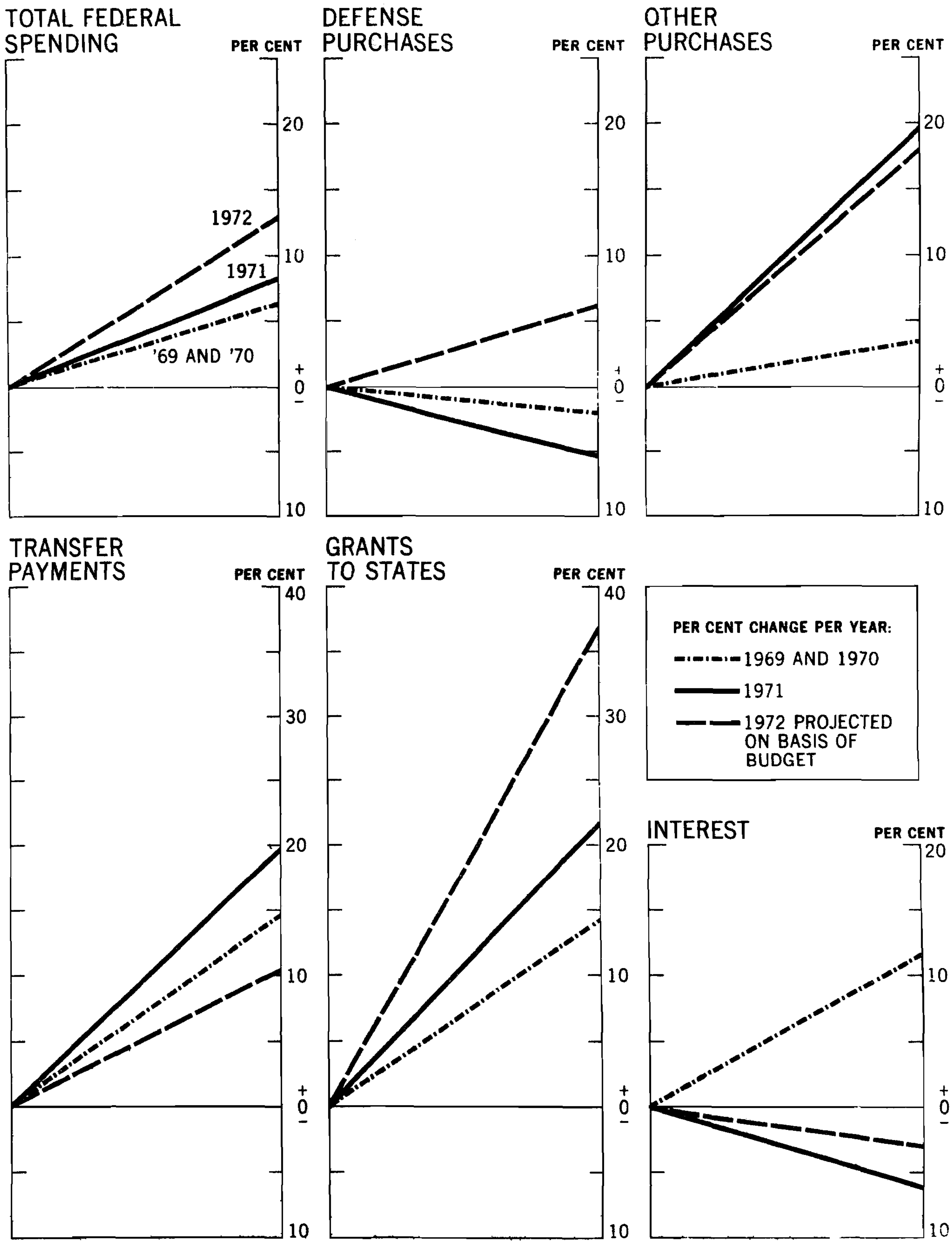
Thereupon the meeting adjourned.

Secretary

CHART 1 ATTACHMENT A

GROWTH RATES IN FEDERAL SPENDING

NIA BASIS - CALENDAR YEARS



F.R. CONFIDENTIAL

Table 1
Changes in Federal Spending
NIA Basis, by Half Years, at Annual Rates, in Billions of Dollars

			Projected by Board Staff		
	1971		1972		1973
	1	2	1	2	1
Total	8.8	9.9	17.0	8.7	6.4
Uncontrollable outlays	6.7	7.9	6.5	5.7	6.8
Pay increases	1.3	.6	4.0	.4	2.4
Transfers to persons	7.7	4.1	3.1	4.6	2.7
Interest and subsidies	-1.9	.2	.6	1.0	1.7
CCC inventories	-.4	3.0	-1.2	-.3	--
Spending subject to some control	2.2	2.0	10.5	-2.0	-.4
Defense	-2.5	-1.8	1.5	-.3	-.3
Nondefense	1.8	1.0	3.4	.1	-1.5
Advance of public assistance grants	--	--	2.0	-2.0	--
Other grants	2.9	2.8	3.6	.2	1.4
General Revenue Sharing	--	--	--	5.0	--

Table 2

Changes in Receipts Due to Changes in Tax Structure
By Half-Years, at Annual Rates, in billions of dollars

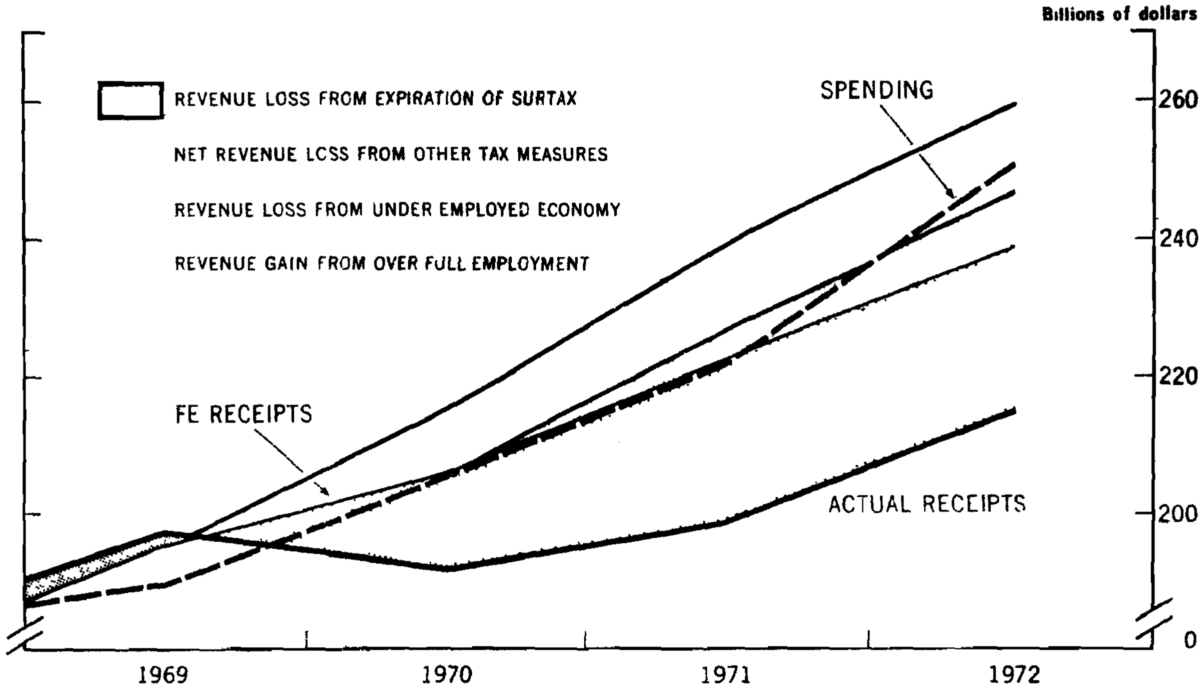
	1971		1972		1973
	1	2	1	2	1
Total	-2.7	-1.5	-4.0	1.0	-1.5
Individual income taxes:1/					
Effect of under-and over-withholding	-2.0	--	5.0	-1.5	-.5
Other changes	-3.0	--	-5.5	-1.2	-2.2
Social security taxes1/	3.5	--	.2	5.0	2.0
Business income taxes2/	-1.2	-2.2	-1.6	--	-.8
Excise taxes2/	--	-1.8	-.8	--	--
Miscellaneous3/	--	2.5	-1.2	-1.3	--

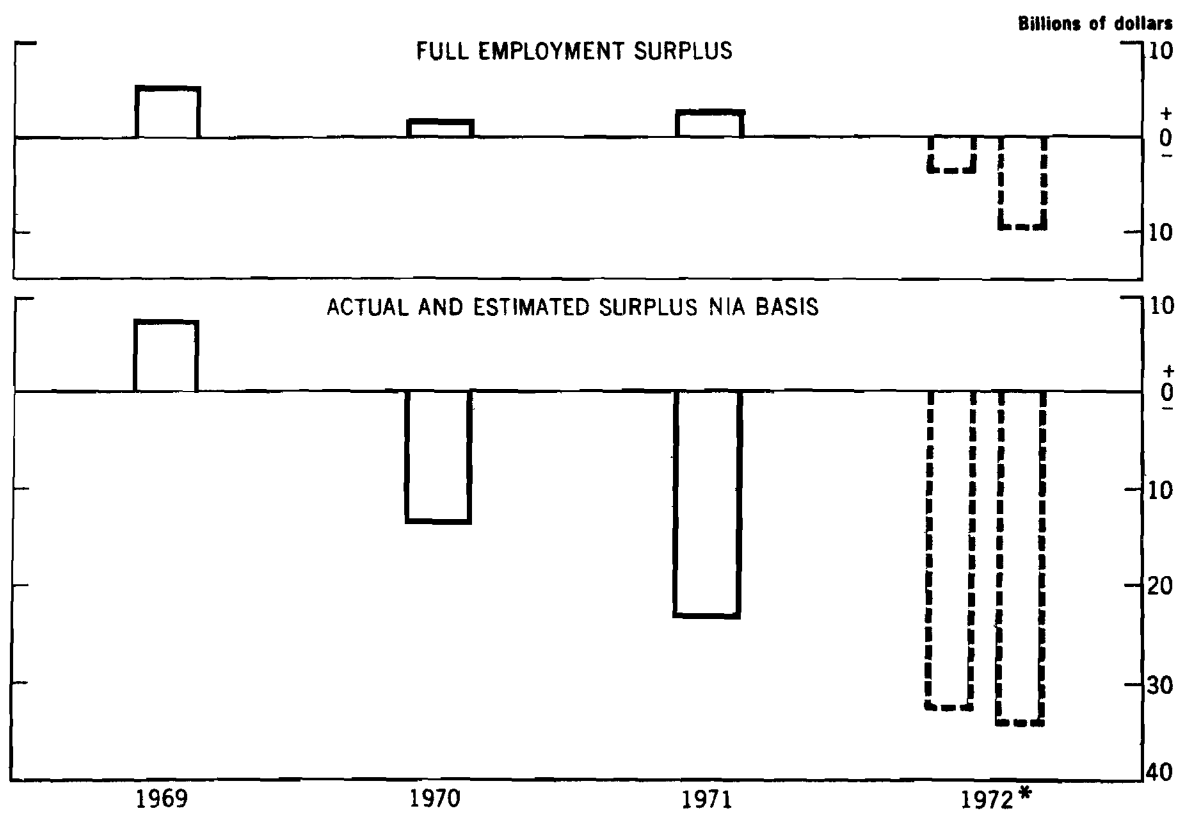
1/ Timed according to cash payments.
2/ Timed according to time of liability.
3/ Includes temporary acceleration of estate and gift tax and import surcharge.

CHART 2

ACTUAL AND FULL – EMPLOYMENT FEDERAL RECEIPTS AND TAX CHANGES

BY CALENDAR YEARS NIA BASIS





*FRB STAFF ESTIMATES

ATTACHMENT B

CONFIDENTIAL (FR)

February 14, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 15, 1972

FIRST PARAGRAPH

The information reviewed at this meeting indicates 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. For the current quarter, growth is projected at a rate close to that of the fourth quarter. Prices increased sharply in December, in part reflecting termination of the 90-day freeze. Wage rates also rose substantially in December when some increases that had been deferred under the freeze were allowed to go into effect, but the rise slowed in January. The narrowly defined money stock, which had not grown on balance from August to November, rose somewhat in December and January. Inflows of time and savings funds at bank and nonbank thrift institutions increased sharply in January, and both the broadly defined money stock and the bank credit proxy expanded rapidly. Some short-term interest rates have declined further in recent weeks while yields on long-term securities generally have increased from the lows reached around mid-January. Exchange rates for most major foreign currencies against the dollar have appreciated to levels near or above their new central values. Since the Smithsonian meeting, capital reflows to the United States have somewhat exceeded the underlying U.S. balance of payments deficit. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to 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, the Committee seeks to achieve bank reserve and money market conditions that will support (I - greater, II - ample, or III - moderate) growth in monetary aggregates over the months ahead.

Alternative B

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to supplying bank reserves at a rate consistent with (I - greater, II - ample, or III - moderate) growth in monetary aggregates over the months ahead, provided that money market conditions do not fluctuate over an unduly wide range.

ATTACHMENT C

STRICTLY CONFIDENTIAL (FR)

FOMC Guidance to Manager

in Implementation of Directive

(as summarized by Chairman Burns
at end of FOMC meeting, February 14, 1972)

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1. Desired rate of growth in aggregate reserves expressed as a range rather than a point target.

2. Range of toleration for fluctuations in Federal funds rate narrower than envisioned by Maisel Committee--enough to allow significant changes in reserve supply, but not so much as to disturb markets.

3. Federal funds rate to be moved in an orderly way within the range of tolerance (rather than to be allowed to bounce around unchecked between the upper and lower limit of the range.)

4. Significant deviations from expectations for monetary aggregates (M_1, M_2, and bank credit) are to be given some allowance by the Manager as he supplies reserves between meetings.

5. If it appears the Committee's various objectives and constraints are not going to be met satisfactorily in any period between meetings, the Manager is to notify the Chairman who will then consider whether the situation calls for special Committee action to give supplementary instructions.