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, September 18, 1973, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Balles
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Holland
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Sheehan
Mr. Debs, Alternate for Mr. Hayes

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

Messrs. Black, MacLaury, and Coldwell, Presidents of the Federal Reserve Banks of Richmond, Minneapolis, and Dallas, respectively

Mr. Broida, Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Andersen, Bryant, Eisenmenger, Gramley, Reynolds, and Scheld, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors
Mr. Feldberg, Secretary to the Board of Governors

Mr. Coyne, Assistant to the Board of Governors
Messrs. Keir, Pierce, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Mr. Ettin, Assistant Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Mrs. Peters, Secretary, Office of the Secretary, Board of Governors

Mr. Fossum, First Vice President, Federal Reserve Bank of Atlanta
Messrs. Boehne and Doll, Senior Vice Presidents, Federal Reserve Banks of Philadelphia and Kansas City, respectively
Messrs. Hocter, Brandt, Nelson, and Green, Vice Presidents, Federal Reserve Banks of Cleveland, Atlanta, Minneapolis, and Dallas, respectively
Mr. Fousek, Economic Adviser, Federal Reserve Bank of New York
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Mr. Broaddus, Assistant Vice President, Federal Reserve Bank of Richmond
Mr. Sandberg, Manager, Acceptance and Securities Departments, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meetings of the Federal Open Market Committee on July 17 and August 21, 1973, were approved.

The memoranda of discussion for the meetings of the Federal Open Market Committee held on July 17 and August 21, 1973, were accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period August 21 through September 12, 1973, and a supplemental report covering the period September 13 through 17, 1973. Copies of these reports have been placed in the files of the Committee.

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

> Since the last meeting of the Committee, the exchange markets have absorbed a lot of bad news with a fair degree of resiliency. The mark rate against the dollar, which serves as sort of a bellwether rate for other European currencies, has moved over a range of no more than 2-1/2 per cent during the past 3 weeks in reasonably orderly trading. Now and then the market has hit an air pocket, but on each occasion we have supplied marks and the dollar rate has bounced back. Our operations now seem to be more visible to the market and may be encouraging private holders of marks to resume normal sales as soon as we put in an appearance. From August 20 through last Friday, September 14, our intervention in marks totaled $63 million, all of which we have subsequently covered in the market. We simultaneously took advantage of a temporary weakening of the Belgian franc to pay down $43 million equivalent of our Belgian franc swap debt through market purchases.
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> Yesterday, the weekend announcement of a 5 per cent revaluation of the Dutch guilder stirred up market speculation that the German mark and Belgian franc might quickly follow suit. After allowing the dollar-mark rate in New York to drop by more than 1 per cent from last Friday's close, we firmly checked any further decline, at an intervention cost of $31 million, and the dollar rate closed somewhat above the low for the day. This morning in Frankfurt, the German Federal Bank stood ready to support the dollar against any further declining tendency, but the rate has stabilized on its own slightly above last night's close. The Federal Bank thinks that our intervention may have helped to bring

this about. The market atmosphere is still a bit tense, however, with some continuing risk of further speculative developments.

By unanimous vote, the System open market transactions in foreign currencies during the period August 21 through September 17, 1973, were approved, ratified, and confirmed.

Mr. Coombs noted that two System swap drawings on the National Bank of Belgium, of $40 million and $25 million, would mature on October 19 and October 26, respectively. While it might prove possible to repay those drawings by maturity, he would recommend their renewal in the event they were still outstanding. Since the Belgian swap line had been in continuous use for more than a year, specific authorization by the Committee was required for renewal.

By unanimous vote, renewal for further periods of 3 months of the two System drawings on the National Bank of Belgium maturing on October 19 and 26, respectively, was authorized.

Chairman Burns remarked that the Special Manager should be commended for the progress that had been made recently in reducing the System's outstanding indebtedness to the National Bank of Belgium. In his judgment, the Committee would want the Desk to take advantage of every reasonable opportunity to make further repayments on that debt. He asked whether any members had a different view, and none so indicated.

The Chairman then invited Mr. Daane to comment on developments at the recent meetings of the Committee of Twenty Deputies and of the Basle group of central bank governors.

Mr. Daane noted that the C-20 Deputies had met in Paris from September 5 through 7. While the press accounts of the progress made at the meeting had been quite pessimistic, he would be inclined to describe the meeting as neither a success nor a failure. On the first day the Deputies--in the words of their Chairman, Jeremy Morse--got off to a bad start when they reviewed a draft document that had been prepared by Mr. Morse and the Vice-Chairmen, a group collectively referred to as the "C-20 Bureau." An effort had been made in the Bureau draft to sketch the area of agreement on the issues of the adjustment process and convertibility that had been reached by the Ministers at their late-July meeting in Washington. However, the European Deputies--most notably, the French, Italians, and Dutch--had now drawn back from the more or less forthcoming position their Ministers had taken in July. With respect to the adjustment process, they did not object to the general notion of a reserve indicator system but they balked at specific proposals for "graduated pressures" to be applied when a country's reserves moved beyond predetermined indicator points. Similarly, on convertibility there was no meeting of minds. Quite clearly, the Europeans felt that the Bureau draft did not go far enough towards their position, under which full settlement of imbalances in reserve assets would be mandatory. The United States was opposed to mandatory convertibility because it regarded the elasticity provided by changes in currency holdings as useful, particularly at times of temporary financial disturbances.

During the second day of the meeting, Mr. Daane continued, the Deputies first met in plenary session to consider questions relating to the exchange rate mechanism and controls. Later they divided into two subgroups; the United States was represented in one by Under Secretary Volcker and in the other by himself. The subgroup he participated in attempted to deal with questions of the valuation of SDR's, the role of gold, and the link between allocation of SDR's and assistance to developing countries. Once again the discussion was inconclusive and more revealing of differences than of agreement.

On the third day, Mr. Daane remarked, Chairman Morse noted that the Deputies had a positive duty to try to reach common ground. He made a strong plea for them to accept a position on the adjustment process fairly close to that set forth in the Bureau draft, which was quite acceptable to the United States. On convertibility, he proposed the acceptance of three propositions: first, a recognition of the principle of convertibility--i.e., that balance of payments deficits should normally be settled in reserve assets; second, a recognition of the need for elasticity in the system, to take account of volatile capital movements and to allow some secular growth in holdings of reserve currencies, within the principle that global liquidity should be subject to international control; and third, an agreement that the mechanisms of convertibility should be left as a matter for further

study. As the discussion proceeded, however, it became evident that the Deputies could not reach agreement on all of those positions. Mr. Volcker then made an alternative proposal, which was ultimately adopted by the Deputies, that the Chairman and Vice Chairmen should develop a draft outline of reform that reflected the best thinking of the Deputies, noting the areas of agreement but also pointing up clearly the areas of disagreement. It was his understanding that that had now been done, and that the document would be available for consideration by the Ministers at the coming Annual Meeting of the International Monetary Fund in Nairobi.

Mr. Daane noted that near the close of the meeting the Deputies also agreed that it would be desirable for them to establish working groups to consider some of the practical and operational problems associated with these matters following the Nairobi meeting--assuming, of course, that they received such an instruction from the Ministers. In connection with the proposed reserve indicator system, for example, there had not yet been a full examination of the question of how reserves should be defined and how base levels should be calculated. Three working groups were envisaged: one, on the adjustment process, would meet in Washington; a second, on intervention and settlement, would meet in Paris; and a third, on consolidation and global liquidity creation, would also meet in Washington.

Turning to the Basle meeting on the following Monday, Mr. Daane observed that the afternoon discussion was among the

most perfunctory in his experience. One of the few highlights of interest was the statement by Governor Richardson that the Bank of England would not ask for a renewal of the 1968 Basle agreement under which other countries had put in place somewhat more than $2 billion of credits to finance any drains on British reserves resulting from liquidation of sterling balances. At the Monday night dinner the entire discussion revolved around Chairman Zijlstra's question concerning the impressions of the governors, who had not attended the Paris meeting, concerning the progress made at that meeting. It was quite clear that the governors had received negative impressions from their deputies. In his (Mr. Daane's) own comments he had pointed out that the meeting had had positive as well as negative results.

In a speech he had given in Zurich on the following day, Mr. Daane continued, he had outlined the issues in international monetary reform and the U.S. position on them, and then had gone on to consider the probable outcome at the Nairobi meetings later this month. While he did not expect definitive conclusions, he thought it was quite likely that some agreement would be reached on a statement of principles that would provide a broad framework for a workable reformed system, including the promise of an effective adjustment mechanism and system of settlement, the recognition that SDR's would be at the center of the reformed system, and an indication of the means for dealing with some of the legacies of the past, including

the overhang of dollars. He also expected that the Deputies would be instructed to begin examining the operational implications of the various reform proposals, an exercise which all of the countries involved appeared interested in undertaking.

Mr. Morris asked for a description of the areas in which common agreement had been reached thus far.

In reply, Mr. Daane said he thought there had been a narrowing of differences, particularly on the adjustment process. There was now a greater acceptance of the view that objective indicators should play an important role in that process, and that reserves were the best objective indicator. Disagreements remained with respect to the amount of reliance that should be placed on the indicators--for example, whether disproportionate movements in a country's reserves should carry the presumption that pressures would be applied against that country or should instead call for consultations with the Fund in which account would be taken of the country's economic prospects, its balance of payments position and prospects, and so forth. Except for that question, there seemed to be general agreement on the adjustment process described in the new draft outline of reform.

On the issue of convertibility, Mr. Daane continued, the United States had agreed that countries maintaining par values should stand ready to convert official balances of their currencies into reserve assets on request, but other countries favored a stricter

rule. On other issues, it was agreed that SDR's should be the principal reserve asset in the new system and should serve as the numeraire for expressing par values, and that the role of gold as well as reserve currencies should be reduced. However, agreement had not been reached on the attributes of SDR's, including their effective yield, nor on the means for diminishing the role of gold. It also was agreed that the flow of real resources to developing countries should be increased, but not whether that should be done by a link between SDR allocation and development assistance or by other means.

Mr. Bryant observed that two other areas of agreement might be mentioned. First, with respect to the exchange rate mechanism, the new draft outline retained the formula reached at the Ministers' meeting in March of "stable but adjustable" par values with allowance for floating rates in particular situations. Secondly, there was a consensus that some means would have to be found for consolidating outstanding reserve currency balances before a new system could be viable, although disagreements persisted regarding the mechanics and the terms of consolidation.

Mr. Mitchell asked whether, in connection with the question of international liquidity, there was agreement with respect to holdings of other countries' currencies as reserve assets.

Mr. Daane replied that there was not. Countries favoring mandatory settlement of imbalances in reserve assets argued that such a system was necessary in order to avoid any inadvertent expansion in international liquidity through increases in holdings of reserve currencies. The U.S. position was that an element of elasticity was needed that would permit temporary disturbances to be accommodated through changes in currency holdings. Also, a number of developing countries preferred to hold their reserves in the form of currencies for the sake of the interest earnings and would oppose an asset settlement system that left them with no control over the composition of their reserves.

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. Gramley made the following statement:

> Economic expansion in the third quarter seems to have proceeded at about as rapid a pace as could be sustained with available industrial capacity and supplies of skilled labor. The staff estimates that real GNP this quarter will show an increase of about 4 per cent at an annual rate--the same rate of gain as registered in private nonfarm output in the second quarter. Industrial production is projected to have risen at a 6-1/2 per cent annual rate relative to the second-quarter average, on the assumption that output will rebound in September, following the August decline. We believe the August dip was due to special factors--including abominable weather over large sections of the country and wildcat strikes affecting the auto

industry. The expected September rebound, however, would be cut short if the new contract between Chrysler and the UAW were not ratified quickly.

If our present estimates prove correct, the pace of real GNP expansion over the summer will have been very close to the 4-1/2 per cent rate of increase we projected in the June Chart Show. But the composition of GNP is different. The upturn in inventory investment that has been "right around the corner" in each of our projections for the past year or more still lies just ahead. Once again, final demands have been quite strong. True, there does appear to have been a decline in defense purchases in the third quarter, but we have no reason to alter our earlier estimates for fiscal 1974. Consumer spending, on the other hand, has held up rather well over the summer, and business fixed investment appears to be registering another good gain.

Indicators of plant and equipment spending seem to have strengthened enough in recent months to warrant a modest upward revision in projected expenditures in this sector between now and mid-1974. This revision raises projected increases in real GNP by about half a percentage point, at annual rates, in each of the next three quarters. This is a relatively small change, so that the contour of the growth path of aggregate real output now projected by the staff is not materially different from what it was a month ago, or at the beginning of the summer. We still think there will be a further slowdown in the growth of real output over the course of the next year.

Evidence supporting such a projection is, I believe, accumulating. Most importantly, conditions in the mortgage market have worsened greatly over the past 2 months, and there is now little room for doubt that housing activity is in for a very substantial decline. Savings outflows at S&L's and mutual savings banks in July and August were worse than we had expected, and there are only fragmentary signs at this juncture of any amelioration of the disintermediation problem. Nevertheless, having written down projected housing starts somewhat in last month's projection, we have not as yet reduced them further. The situation in the mortgage market is still quite fluid and we have not been able to appraise its quantitative significance for our housing projection. It would not surprise me, however, if new housing starts fell faster and further than presently estimated.

In the industrial sector, too, a degree of cooling off of earlier feverish demands has begun to be discernible. In the labor markets, for example, we have seen over the past several months a leveling out of the workweek in manufacturing and a slight decline in overtime hours. The factory layoff rate has stopped declining and the accession rate has stopped rising. Growth in the civilian labor force also has moderated. At the same time, the rate of new business formation has shown a leveling tendency; the aggregate inventory-sales ratio may now be bottoming out because of slower growth in sales, and the index of vendor performance--that is, the percentage of reporting companies in the Chicago area indicating slower deliveries--no longer is rising.

These are hopeful signs, but they do not mean we are out of the woods yet. Shortages of industrial materials, parts, and supplies are still widespread, and are at least as severe now as they were at the beginning of the summer. Skilled labor also remains in short supply, despite the recent moderation in demands for labor, and industrial capacity is hard pressed.

The near-term outlook for prices, furthermore, is poor. Retail food prices seem likely to rise further through the fourth quarter despite recent declines in some agricultural prices, and nonfood commodity prices will also surge as an aftermath of the earlier freeze. Next year, pressures on costs from more rapid increases in wage rates, together with slower productivity gains, seem likely to plague us even if excess demand is eliminated.

In my view, there is relatively little that public policy can do to improve the near-term outlook for prices. The urgent task is to ensure that aggregate demand slows somewhat further, and then remains at a moderate pace long enough for the inflationary processes of recent years to unwind. But it is equally urgent to accomplish this without precipitating a recession. If economic activity weakens too much next year, the pressures to reopen the monetary spigot would almost certainly become too powerful to resist.

Chairman Burns said he thought it would be desirable for the Committee to have a thorough discussion of the economic and financial outlook today because of the unusual difficulties at present in assessing that outlook. In his view it would be helpful

for the Committee to hear the reports of Messrs. Holmes and Axilrod before it turned to a review of the state of the economy and the desirable course for monetary policy.

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 August 21 through September 12, 1973, and a supplemental report covering the period September 13 through 17, 1973. 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:

> Financial markets were exceptionally sensitive to expectational changes over the period since the Committee last met, resulting in substantial day-to-day swings in money market conditions and in security prices. Despite the continued strong performance of the economy and evidence of substantial inflationary pressures, there was a further development, over much of the period, of the view that the System's next move would be towards ease. This substantial improvement in investor psychology--together with a strong technical position of security markets--led to rather sharp declines in intermediate- and long-term rates as market participants sought to acquire securities in the belief that interest rates had reached their peak.
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> The Board's announcement on September 7 of an increase to 11 per cent in marginal reserve requirements against CD's and related instruments and subsequent statements by Chairman Burns about the need for continued monetary restraint caused a market reassessment of the outlook for interest rates, particularly with respect to the timing of any movement towards lower rate levels. At the moment there is a fairly sharp division of opinion among market participants. Some view the increase in marginal reserve requirements as merely an expression of System dissatisfaction over the ability of banks to moderate

credit expansion, and these participants take great comfort in the evidence of a slowing in M_1 growth. Others view the move as a signal that monetary pressures will be maintained and perhaps even intensified and that interest rates, particularly short rates, will move higher before peaking out later in the year. Yesterday's strong rally in the markets indicates that for the moment, at least, the bulls are predominating over the bears.

Long-term interest rates were substantially lower on balance over the period--even after some increases last week. However, movements in short-term rates were erratic and mixed. The prime rate, of course, has reached 10 per cent at a number of banks. There was a sharp drop in Treasury bill rates early in the period, but then rates moved irregularly higher as dealers built up inventories, competition from other money market instruments--particularly CD's--expanded, and there was net foreign official selling of Treasury bills. Yesterday, however, rates again moved sharply lower. In yesterday's regular Treasury bill auction average rates of 8.79 and 8.83 per cent were established for 3- and 6-month Treasury bills, respectively, down 12 and 2 basis points from the rates established just before the last Committee meeting. Bidding yesterday on the 6-month bill was exceptionally strong and in our own bid for System Account we managed to wind up on the stop out. As a result, we will be redeeming $125 million of bills, which we had not planned to do.

As you know, the Treasury was forced to borrow directly from the System prior to the September tax date, even though it raised $2 billion in cash by the sale of a 25-month note on August 24. Since September 7 direct borrowing has been outstanding on all but one day, with the volume reaching a peak of $443 million on September 11. The Treasury's balance is expected to build up rapidly from now on and no further cash need is expected until early November. The balance will, of course, be bolstered by about $1.2 billion as the Treasury monetizes gold following the signing of the gold bill.

The terms of the Treasury cash financing as compared with the auction results reflect the volatility of the market during much of the period. Because of market uncertainties, the Treasury delayed placing a coupon on the issue until 2 days before the auction. An 8-3/8 per cent coupon appeared reasonable at that time, although there was some concern as to whether it would be generous enough to make the issue a resounding success. In the event, the

market improved enough in those 2 days to result in a substantial premium in the auction. The average yield was established at 7.94 per cent, over 40 basis points lower than the coupon rate that had seemed reasonable 2 days before. There was considerable interest from individual investors, particularly in those reserve districts, such as Cleveland, where extensive publicity had been given to the financing.

Open market operations over the period were directed at restricting reserve availability in order to limit the growth of the monetary aggregates, and particularly of RPD's. As had been widely anticipated at the last meeting, early in the period RPD's appeared to be growing more rapidly than the shortened 11-13 per cent range of tolerance adopted by the Committee. Accordingly, we planned to be even more grudging in the supply of reserves through open market operations, expecting that the Federal funds rate would move upward toward the 11 per cent ceiling specified by the Committee. As the period progressed, however, the growth rate of the monetary aggregates tended to slow--with M_1 actually turning negative--and late in the period RPD's appeared to be back within the tolerance range. It could be argued that the weakness in M_1 should have called for a more liberal supply of reserves and an easing of money market conditions. However, given the state of market expectations and the proximity of this meeting of the Committee, we have been endeavoring to keep reserve conditions steady, expecting a Federal funds rate of about 10-3/4 per cent--the level actually achieved early in the period.

I should note that in the past two statement weeks there has been a pronounced drop in the level of borrowing at the discount window. Early in the period, borrowings were averaging well over $2 billion and they were especially heavy near the Labor Day weekend. Subsequently, however, borrowings dropped to about $1.5 billion. Presumably this reflects in part the shift of funds away from money center banks--which rely heavily on the funds market--as the Treasury made daily 100 per cent calls against tax and loan accounts at the big banks. It may also reflect the efforts of our discount officers to discourage overuse of the window as well as the desire of some banks to keep their records clean. In any event, it has resulted in a situation where the banking system has shifted from use of the discount window, putting greater pressure on the Federal funds market. Consequently, we have had to supply more nonborrowed reserves through open market operations than

we had expected in order to keep the Federal funds rate within the constraint adopted by the Committee. Perhaps this situation will be corrected as the Treasury balance moves back into a more normal condition.

Day-to-day operations over the period had to be quite flexible as the Desk had to cope 1) with rather erratic reserve management on the part of the banks, 2) with the need to offset the large supply of reserves caused by the decline in the Treasury's cash position, and 3) with the sensitivity of the market to any change in money market conditions. In most weeks during the period we found ourselves supplying and absorbing reserves at different times. On balance, I believe we were able to maintain the relative stability in money market conditions that I think was essential in a period of major speculation about the future course of monetary policy.

Looking ahead, it appears likely that markets will continue to be volatile. Market participants want badly to believe that interest rates have peaked or are about to do so. Attention will again be riveted on M_1 statistics as they are published, on day-to-day fluctuations in the Federal funds rate, and on System responses in the open market. I believe we will have to continue to be quite flexible in our day-to-day operations.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 21 through September 17, 1973, were approved, ratified, and confirmed.

Mr. Axilrod then made the following statement on prospective financial relationships:

I have little to add today to the blue book 1/ analysis of alternatives. The fundamental point made there is that a reserve strategy designed to keep M_1 from remaining considerably below a long-run 5-1/4 per cent growth line appears to entail declining interest rates in the months ahead. The Committee may, of course, be willing to see some shortfall from that long-run path, partly because there may have been a downward shift in demand for M_1 in response to the new time deposit offering rate structure.

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

But if the Committee wishes to accept only modest shortfalls, this too appears to involve some decline of market interest rates.

These conclusions are reached because further restraint on money demand can be expected in the months ahead from the lagged effects of the sharp rise in short-term interest rates of the past few months. The various kinds of econometric evidence we have and also judgmental projections point this way.

In framing its policy strategy between now and the next meeting, however, the Committee may wish in addition to consider the following points.

(1) The rate of growth in nominal GNP is projected by the staff at around 9 per cent over the next two quarters, so that the pull of transactions demand will be relatively strong. If our estimate of the lag between interest rates and money demand is too long--and there is considerable dispute about the length of lag--money growth could snap back earlier than anticipated and with a lesser decline in interest rates.

(2) The outstanding amount of the money stock has only just now dropped below path levels, and the Committee may wish to see a bit more evidence that it is tending to stay below before permitting any significant easing in money market conditions.

(3) Market expectations are very sensitive at this point. An easing in money market conditions--should it develop--could trigger fairly considerable declines in short-term and also to a degree long-term market interest rates. The restraint currently built into credit markets could be rather quickly eroded, and spending plans on the margin of being cancelled might be revived.

These three points of course argue for caution in permitting any easing in money market conditions. And they are why the staff has suggested that the Committee might wish to continue to include in the operational paragraph of the directive 1/ the reference that instructs the Manager to take account of domestic financial market conditions.

On the other hand, there are arguments the Committee may wish to consider that would suggest the desirability of some judicious widening of the prevailing Federal funds rate range on the down side.

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

(1) While staff estimates have often been wrong as to the specific amount and timing of the cumulative impact of interest rates on money demand, they have seldom been wrong as to direction and general order of magnitude of effect.

(2) An early start in restoring growth in monetary aggregates to a longer-run path will ease control problems later on. It will reduce the risk that the Committee may get so far off its desired path that it cannot, for all practical purposes, move back on within a reasonable time frame and without setting in motion a cumulative monetary expansion difficult to contain.

Given the nature of the lags involved, such problems of monetary strategy become more difficult to handle the longer monetary aggregates stay off path. At this time, because shortfalls in M_1 have not yet been prolonged, strategy dilemmas may be less acute.

Chairman Burns asked whether the members had any questions they would like to direct to the staff.

Mr. Mayo inquired about the staff's assessment of the implications of the tentative wage settlement that had just been reached between Chrysler and the UAW.

In reply, Mr. Gramley said his information regarding the settlement was limited to a report in this morning's papers that the terms called for a first-year increase in wage rates of 6.2 per cent. He would hesitate to speculate from that one piece of evidence about the implications of the agreement for wage rates generally. If the tentative settlement was ratified soon enough to limit the loss of production time to about one week, the effect of the strike on industrial output in September would be rather small.

Mr. Mayo remarked that willingness of the union to agree to a first-year wage increase of only 6.2 per cent would suggest a considerable degree of restraint on the part of labor, given the magnitude of recent and prospective advances in the cost of living. Such restraint was, of course, highly pleasing, but as an economist he found it difficult to understand.

Chairman Burns observed that, while he shared Mr. Mayo's satisfaction with the magnitude of the wage increase in question, he would not be inclined to draw any conclusions about the likely size of settlements in other wage negotiations. Trade unions had their own bureaucracies, and it was his impression that they resembled other bureaucracies in functioning with a lag.

Mr. Daane referred to Mr. Holmes' comment about the sensitivity of the market to changes in money market conditions and asked whether the Committee had any flexibility with respect to the Federal funds rate if it wanted to avoid giving misleading signals to the market.

In reply, Mr. Holmes observed that market participants were watching the funds rate extremely closely, so that room for movement was quite limited if undesired inferences about policy intent were to be avoided. However, a small shading in either direction probably would not have much effect on attitudes if the change was not a continuing one.

Mr. Daane then remarked that he had some difficulty in interpreting recent developments in industrial production. According to the supplement to the green book[1/], the downturn in the Board's index in August was attributable to a large curtailment in auto and truck assemblies resulting from special factors; abstracting from that component, the index would have risen by 0.5 per cent. While such an increase would be less than that recorded in July, it was not clear to him whether that should be taken to confirm the earlier indications of a slowing this year in the growth rate of production. Moreover, he was not sure about the extent to which the August slowing reflected supply constraints rather than demand factors.

In reply, Mr. Gramley said he would not attach any great significance to the slowing of the index in August, partly because it reflected only one month's developments and partly because the factors curtailing output in the auto industry--primarily weather--might well have affected other industries also. He might also note that as a result of upward revisions in the original figures for June and July the rate of increase in production appeared to have risen somewhat from the rate to which it had slowed in the spring. As to the role played by supply constraints in recent production developments, it was

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

his impression that the supply situation was perhaps a little worse now than it had been in the spring, but the difference probably was not very great. For example, while the rate of capacity utilization in major materials industries appeared to have risen further in the second and third quarters, the pace of advance was considerably slower than earlier.

In response to questions by Mr. Black, Mr. Axilrod said the staff did not have any less--or any more--confidence than usual in the accuracy of the blue book estimates of the relationship between monetary aggregate growth rates and money market conditions, nor did it believe that it was more likely to have erred in one direction or the other in assessing the prospects for growth in the aggregates under the various alternatives. A point he had attempted to make in his statement was that, because the growth rate of M_1 had only recently dropped below its longer-run target path--and because the Committee would now be extending the horizon for target growth rates to next March--the members might feel that they could afford to take somewhat greater risks of delaying in easing money market conditions at this time than, say, in 2 or 3 months.

Mr. MacLaury noted that, despite the upward revisions in the staff's projections of growth rates in real GNP, the rise between the fourth quarters of 1973 and 1974 was still

expected to be only 1.5 per cent. He asked whether the staff had recently modified the extent to which it relied on purely econometric forecasts in preparing its projections, and whether the relationship between the econometric and judgmental projections had changed recently.

Mr. Gramley replied in the negative to both questions. He added that the purely econometric projections continued to suggest slower growth than those shown in the green book for the latter part of 1973 and on into 1974 and that the magnitude of the difference was not appreciably greater now than it had been earlier. The econometric projections suggested a somewhat slower expansion in business fixed investment. They also suggested significantly lower levels of personal consumption expenditures for given levels of nonconsumption outlays; that is, they yielded higher figures for the rate of personal saving. Only time would tell which set of projections was closer to the mark.

Mr. MacLaury then observed that during the latter part of the recent intermeeting period the Desk had seemed to be following a set of principles different from those in effect earlier. While the Committee had decided at the previous meeting that somewhat more emphasis than usual should be placed on RPD's in open market operating decisions, it had not

concluded that M_1 and M_2 should be ignored. However, the Desk had not moved in the direction of ease after September 7, when estimates of RPD growth for the August-September period had declined to roughly the midpoint of the lowered range specified by the Committee and estimates for both M_1 and M_2 had fallen below the bottoms of their ranges. As he understood the Manager's comments today, the Desk had been concerned about the sensitivity of the market to signs that a possible inflection point had been reached in monetary policy. He (Mr. MacLaury) did not dispute the proposition that market participants were carefully watching System operations at present. That justification disturbed him, however, because it could be extended to call for avoiding changes in market conditions for long periods if such expectations persisted.

Mr. Holmes noted that, as he had indicated earlier, one could argue that the weakness in the monetary aggregates that emerged during the period should have called for easing a bit. It had seemed desirable to postpone such action, however, because as of September 7 the shortfalls had been evident only in the latest week's estimates and because the date of the Committee's next meeting was close. He might note, moreover, that even though money market conditions were no easier after September 7 than before, the Desk had lowered its sights for

the funds rate. Early in the period, when the aggregates were strong, the Desk had sought to supply reserves at a pace consistent with an 11 per cent funds rate, but the rate in fact had risen to an average level of only 10-3/4 per cent. Later the Desk had abandoned that earlier intention and had successfully pursued a reserve strategy consistent with no further increase in the funds rate.

Mr. Mayo remarked that his reaction to open market operations during the past 2 weeks was similar to that expressed by Mr. MacLaury. Having participated in the daily conference call since the preceding meeting, he had had an opportunity to observe operations closely. He had become increasingly restive about the Desk's day-to-day program of operations after September 7, when the estimate of the 2-month growth rate in RPD's was near the middle of the 11 to 13 per cent range and that for M_1 was negative. Although he had shared the concern of other Committee members about the risk of giving wrong signals to the market, he thought the Desk's approach was unnecessarily cautious in that regard and that it was unduly worried about the consequences of a decline in the average funds rate of one-quarter, and perhaps even one-eighth, of a percentage point. In his view, the average funds rate could have been permitted to decline to 10-1/2 per cent without incurring any serious risks. Incidentally, with

the benefit of hindsight he believed the Committee had set too narrow a range for RPD's at the previous meeting; rather than 11 to 13 per cent, it would have been better to employ the 11 to 15 per cent range that had been considered at one stage of the discussion.

Mr. Daane said he did not share the views of Messrs. MacLaury and Mayo regarding open market operations since September 7. As of that date, the estimate of the August-September growth rate in RPD's was still a bit above the mid-point of the range of tolerance, and in light of the emphasis the Committee had placed on RPD's at the previous meeting he would have been disappointed if the Desk had permitted the funds rate to edge down. He wondered whether Messrs. MacLaury and Mayo had been unhappy with the indicated growth rate in RPD's and whether they thought a shading of the funds rate down to 10-5/8 or 10-1/2 per cent would have had any significant effect on the growth rate of M_1.

Chairman Burns suggested that it might be better for the Committee to focus on policy for the future rather than to continue to debate the appropriateness of past operations.

Mr. Mayo commented that in his judgment the issue under discussion was not of very great moment; he did not consider the difference between Federal funds rates of 10-3/4 and 10-1/2 per cent to be particularly important. He had simply

wanted to express his view that a little more flexibility with respect to money market conditions would have been desirable in the Desk's approach to operations so long as RPD's were well within the range of tolerance and the monetary aggregates were weak. His object was not to second-guess the Desk but to help insure that the Committee would do the best it could in formulating its instructions for the coming period.

Mr. Holland asked whether Mr. Holmes had seen any indications of changes in operating strategy at major money market banks in the wake of the recent increases in marginal reserve requirements on large-denomination CD's.

Mr. Holmes replied that there certainly had been a tendency for major banks to seek term funds in preference to relying on the overnight Federal funds market. There also had been reports that the volume of funds sales by some smaller banks was not as large as formerly, because of either deposit outflows or strong loan demands at those banks. Such a development would encourage the major banks to turn increasingly not only to term funds but also to the Euro-dollar market, at least when the rates there were competitive. There also was a great deal of talk about changes in loan policy, but of course banks had a fair volume of loan commitments outstanding which they felt obligated to meet.

Mr. Holland then said he assumed Mr. Axilrod would agree that the recent changes in Regulation Q had resulted in a stock-adjustment process which was temporarily depressing demands for money, narrowly defined. He asked how long such a process might reasonably be expected to last.

Mr. Axilrod replied that different models had been used in an effort to estimate the magnitude and duration of the effect Mr. Holland had mentioned, and the diverse results obtained had been taken into account in developing the judgmental projections included in the blue book. He might note that the large quarterly model indicated that the effect was very large initially--growth rates in M_1 were reduced by roughly 3 percentage points during the first quarter--and that it lasted for three quarters, diminishing after the first. He was inclined to believe that those results showed too large an effect. He was somewhat concerned about the uncertainty as to the strength of the stock adjustment. More generally, he had some concern that M_1 growth might in fact rebound more than projected as the year progressed, assuming nominal GNP expanded at the rate anticipated. That concern accounted in part for the tentative tone of his presentation earlier today.

Mr. Eastburn said it was his impression that the projections for housing starts shown in the green book implied a larger decline than had occurred in either 1966 or 1969. Moreover, Mr. Gramley had observed in his statement that he would not be surprised if housing starts fell faster than currently projected. He wondered why Mr. Gramley expected the performance of housing to be so much poorer than during the two earlier periods of credit restraint, particularly in view of the presumed improvement in Government financing facilities since 1969.

Mr. Gramley said he assumed Mr. Eastburn was measuring the current decline in housing starts from the level in the first quarter of 1973 to the projected trough in mid-1974. He would be inclined to argue that the contraction during the spring was a consequence not of credit restraint but rather of overbuilding and rising vacancy rates. The projections for housing starts would be revised downward significantly only if developments suggested that there was good reason to expect the disintermediation problem to remain very serious at savings and loan associations. That was a possibility, particularly in the first quarter when many S&L's would have large amounts of certificates maturing. On the other hand, there were fragmentary indications that the problem might have begun to ameliorate in early September.

Mr. Sheehan remarked that the discussion in the current blue book appeared to imply a shift toward less emphasis on the monetary aggregates and more emphasis on interest rates than had been the case earlier under the experiment the Committee had been pursuing since February 1972. In March of this year the Committee had adopted a 5-1/4 per cent growth rate in M_1 as its longer-run target, and at subsequent meetings it had reaffirmed that target for the period through the end of the year. Now, however, the blue book suggested that the Committee should abandon its earlier objective for M_1 because its attainment would involve an undesirably large decline in interest rates. He asked whether the staff had meant to indicate that interest rates should be given greater weight now than they had been earlier.

Mr. Axilrod replied that that had not been the staff's intention; insofar as the current blue book differed from its predecessors, the difference reflected changes in real-world relationships rather than in the staff's approach to its assignment. As in previous blue books, one of the policy alternatives--that labeled C this time--incorporated an assumption of unchanged money market conditions among its specifications. Under that alternative, the M_1 growth rate over the fourth and first quarters was estimated at 3 per cent. Ordinarily, one of the alternatives

presented involved the maintenance of whatever longer-run target for M_1 the Committee had adopted at its previous meeting. In the staff's judgment, however, the attainment of the target level for December implied by the 5-1/4 per cent growth path previously agreed upon would require an extremely sharp decline in the funds rate--perhaps to 1 or 2 per cent in the near term. Since that seemed outside the range of reasonableness, the staff had instead set forth--under the heading of alternative A--a set of specifications that would return M_1 to the 5-1/4 per cent path by March 1974. As indicated in the blue book, it was expected that such a growth path for M_1 would be associated with rather substantial declines in interest rates and a rebound in M_2. The remaining alternative--B--involved specifications for the aggregates and interest rates that were intermediate to those of A and C. He might add that in his judgment a delay from December to March in the return of M_1 to the 5-1/4 per cent growth path would have little or no effect on the economy. If the return was delayed much longer, however, some effects would begin to emerge.

Mr. Sheehan noted that under alternative C the growth rate in M_1 for the fourth quarter was shown as 2.6 per cent; together with the 1.2 per cent rate indicated for the third quarter, that implied an average rate for the second half of

1973 of only 1.9 per cent. He asked whether it would still be possible to get M_1 back on the longer-run 5-1/4 per cent path by March if the Committee were to adopt alternative C today.

Mr. Axilrod replied that if money market conditions were kept unchanged at present--as suggested under the C specifications--it would still be possible for M_1 to return to the indicated path by March. According to the blue book analysis, however, interest rates would have to decline more later on than they would if some move toward easier money market conditions were made now. That was one implication of the evidence relating to the lagged relationship between changes in interest rates and in monetary growth rates. As he had noted in his statement, however, growth in nominal GNP at the 9 per cent rate projected for the next two quarters would normally be associated with a substantial rise in transactions demands for money. There was a real conflict at the moment between the implications for money growth of the lagged effects of high interest rates on the one hand and the current effects of rapidly rising transactions demands on the other.

Mr. Sheehan then asked Mr. Gramley how long he thought growth in M_1 could be held to a low rate without incurring serious risks for the economy over, say, the first three quarters of 1974. In particular, would a 1.9 per cent growth rate in M_1 over the last half of 1973 offer grounds for concern?

In response, Mr. Gramley said that if interest rates were not advancing he would not be greatly concerned about two quarters of relatively slow growth in M_1, particularly after the sizable increases recorded in 1972 and in the second quarter of this year. Such a period of slow monetary growth--assuming it was followed by a return to a growth rate on the order of 5 or 5-1/2 per cent--would not imply an increasingly restrictive policy; it would reflect the effects on the economy of past policies, and those effects had already been taken into account in the GNP projections. He would be concerned, however, if interest rates were pushed up to still higher levels in the effort to hold M_1 growth to a low rate in the first half of 1974.

Mr. Balles noted that Mr. Gramley had concluded his statement today with the observation that public policy could do little to slow the rate of price advance in the near term and that its urgent task was to moderate aggregate demand somewhat further without going so far as to precipitate a recession. In that connection, he wondered whether the staff had attempted to quantify the implications for real growth, prices, and unemployment of the three alternative policy courses described in the blue book, perhaps by making simulation runs of its econometric model. He was particularly concerned about those

implications because he thought the method used for calculating the longer-run monetary growth rates shown in the blue book resulted in overstatements of the prospective increases. That method, which involved determining the annual rate of change from the level in September 1973 to the expected level in March 1974--that is, between the final months of the third and first quarters--yielded expected growth rates for M_1 of 6, 4-1/2, and 3 per cent under alternatives A, B, and C, respectively. In his judgment the more valid procedure was to calculate the annual rate of change between the monthly average levels of the third and first quarters. On that basis the expected growth rates would be lower: 4.9, 3.7, and 2.4 per cent, respectively, for the three alternatives.

Mr. Gramley replied that the staff had not worked out the implications of the specific policy alternatives set forth in the blue book. It had, however, made simulation runs of the model on the assumptions that from the fourth quarter on the growth rate of M_1 would be stepped up--and, alternatively, stepped down--by one percentage point from the 5-1/4 per cent rate assumed in the basic projection. The results indicated that, with a one-point reduction in the M_1 growth rate, in the second half of 1974 the rate of expansion in real GNP would reach zero and then become slightly negative and the unemployment rate would rise to about 6 per cent. The effect on prices

through the latter part of 1974 was smaller; the fixed-weight GNP deflator would be rising then at a rate of 4.3 or 4.4 per cent, not very different from the 4.6 per cent rate projected in the basic model. Such results would be consistent with the wide variety of evidence indicating that the initial impact of a change in policy was mainly on output and that the effects on prices were spread over a longer period.

With a one-point increase in the M_1 growth rate, Mr. Gramley continued, real output would be rising at a rate of 2-1/4 to 2-1/2 per cent in the second half of 1974--somewhat more than in the basic model. Unemployment would remain at about 5.1 or 5.2 per cent instead of rising to 5.5 per cent as now projected, and the fixed-weight deflator would be advancing at a rate in the 4-3/4 to 5 per cent range.

Mr. Balles remarked that like Mr. Sheehan he was disturbed about the possible consequences of a continuation of rather low rates of growth in M_1, such as those specified in alternatives B and C, and the projections cited by Mr. Gramley tended to reinforce his concern. He asked whether Mr. Gramley had any fears that the alternative B or C policy courses might precipitate the recession he had cautioned the Committee against in his statement.

Mr. Gramley said he might respond in the same manner as he had to an earlier question: he would not be unduly concerned about the risks of a recession if the low M_1 growth rates were limited to the remainder of 1973 and perhaps the very early part of 1974, but he would be concerned if interest rates were raised further in order to maintain the low growth rates for a longer period.

Chairman Burns added that one should also bear in mind the change in meaning of particular growth rates for M_1 as a result of the stock adjustment produced by Regulation Q changes, which Mr. Holland had mentioned earlier.

Mr. Axilrod said he might make a technical point regarding Mr. Balles' comments on alternative methods of calculating M_1 growth rates. He did not mean to debate the question of how growth rates should be calculated for particular purposes, and he certainly agreed that the method of comparing quarterly averages was economically meaningful. He would note, however, that while that method yielded lower growth rates than the blue book method for the fourth-first quarter period, it yielded a higher rate for the third quarter. Specifically, the third-quarter growth rate would be about 5.5 per cent under Mr. Balles' method, in contrast to the 1.2 per cent rate shown in the blue book.

Mr. Balles remarked that Mr. Axilrod's point was well taken. He went on to say that earlier comments by Mr. Axilrod and Mr. Holmes seemed to suggest that declines in interest rates at this point could involve risks in addition to that of giving false signals to the market regarding the Committee's policy intentions. So long as the rate declines were not expected to preclude achievement of the desired growth rates in the monetary aggregates, it was not clear to him why they should be a matter of special concern.

In reply, Mr. Axilrod said he might first note that, in his view at least, monetary policy influenced the real economy through the channel of interest rates and credit conditions; the justification for setting policy goals in terms of monetary aggregates was that one could not specify with certainty the interest rates and credit conditions needed at any particular time. At present, a great deal of restraint existed in mortgage markets, and he believed that many businessmen were on the margin with respect to canceling or proceeding with their capital spending plans. Because of the effect on expectations, a substantial decline in the funds rate now undoubtedly would lead to an abrupt fall in short-term market rates and some decline in long-term rates. Such rate declines would immediately affect attitudes in mortgage markets, undoing some of the restraint in place there. They also would induce many businessmen

to move ahead with capital spending plans in order to take advantage of lower long-term rates which, they would reason, might well prove temporary.

In short, Mr. Axilrod continued, the effects of a significant decline in the funds rate at this point could quickly extend beyond attitudes of investors to the real economy. There would be nothing wrong with such a development, so long as the Committee believed that this was the proper time for it. The range of policy options available to the Committee varied with circumstances, and in his judgment this was a point at which the Committee had a choice between starting early or waiting a bit before easing very much. There was, of course, a risk of delaying too long, but the Committee could also opt to proceed cautiously now--partly because of the possibility that the rate of monetary growth might move up more than expected as a result of strong transactions demands associated with large increases in nominal GNP.

Mr. Holmes said he might mention one other aspect of the matter--namely, that any confirmation of market expectations of an easing in policy could result in an explosion of demand for securities, both by banks and their customers, and thus to sharp increases in bank credit. Thus, assuming bank credit was included among the aggregates of interest to the Committee, declining

interest rates were not likely to be consistent with desired growth rates.

Mr. Fossum noted that, according to the staff's projections, the rate of expansion in consumer expenditures would be slowing in the fourth quarter of 1973 and in 1974. In light of that prospect, he wondered how the staff would assess the desirability of imposing a surcharge on personal income taxes.

Mr. Gramley remarked that a tax surcharge would have the desirable effects of redressing the distribution of restraint from housing to consumption expenditures and of contributing to a better balanced program of aggregate demand management by reducing the burden on monetary policy.

In reply to a question by Mr. Winn, Mr. Gramley said the available information suggested that the decline in defense spending which apparently was occurring in the third quarter would be reversed shortly and that it carried no implications for the aggregate volume of such spending in fiscal 1974.

Mr. Winn then observed that there had been a marked increase over the past year in the share of consumer credit extensions accounted for by finance companies and a decline in the share accounted for by banks. He asked what significance might be attached to that development.

Mr. Gramley replied that it was normal in a period of monetary restraint for the banking system's share of total financing to decline and for the share of other types of lenders to increase. While he did not have data at hand regarding the magnitude of the shift in the current period, he would have expected it to be smaller than in past periods of restraint because, as a result of the removal of Regulation Q ceilings on large-denomination CD's, banks had been able to continue acquiring funds through that channel.

Mr. Coldwell asked Mr. Axilrod to assess the probable effects on actual and prospective growth rates in M_1 of recent regulatory actions and any other special developments that might be relevant.

Mr. Axilrod replied that in his judgment the Regulation Q changes were of principal importance in that regard because they directly influenced the demand for money. As he had indicated in his earlier response to a related question by Mr. Holland, the large quarterly model suggested that the resulting stock adjustment would have the effect of reducing the M_1 growth rate by 3 percentage points in the first following quarter. His best guess was that the actual effect would be about half of that; that is, assuming interest rates were the same, in the absence of the Q change third-quarter growth in M_1 would be at a rate

of about 2.7 per cent, rather than at the 1.2 per cent rate presently estimated. In subsequent quarters the effects would be less; at a maximum, he thought the alternative A, B, and C growth rates shown in the blue book for the fourth and first quarters combined would be increased by one-half to one percentage point in the absence of the Q change.

Chairman Burns then suggested that the Committee dispose of certain other items of business before proceeding with its deliberations on the economic outlook and the appropriate direction of monetary policy. First, it might be desirable for the Board members and Reserve Bank Presidents to have a dinner meeting on the day before the next FOMC meeting--that is, on the evening of Monday, October 15--for the purpose of holding an unstructured discussion of matters of common interest.

There was general agreement with that suggestion.

The Chairman added that only a limited number of matters could be covered in such a meeting. While he did not plan on having a formal agenda, it would be helpful to him to know of any matters that others would like to have taken up. Suggestions might be sent either to him or to the Committee's Secretary.

Chairman Burns then noted that the Committee had planned to consider today a memorandum from the Secretariat, dated

August 14, 1973, and entitled "Proposed actions with respect to bankers' acceptances." 1/ He asked Mr. Broida to comment briefly on the recommendations contained in the memorandum.

Mr. Broida observed that the recommendations in question had two ultimate objectives, of which one was technical and one substantive. The technical recommendation was for a simplification of the System's rules and regulations in the area of bankers' acceptances. At present, paragraph 1(b) of the Committee's authorization for domestic open market operations indicated that the New York Bank could buy and sell acceptances "of the kinds designated in the Regulation of the Federal Open Market Committee." That Regulation, in turn, indicated that the Desk could trade in acceptances "of the kinds made eligible for purchase under Part 202 of this chapter [Regulation B]." The Board's Regulation B, entitled "Open market purchases of bills of exchange, trade acceptances, and bankers' acceptances," was given life only through that reference in the Committee's Regulation, because the Board had not had statutory authority to regulate System open market operations since the FOMC was established in its present form in 1935.

The staff's technical recommendation, Mr. Broida continued, was that the Committee agree in principle to delete

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

the reference to Regulation B from its own Regulation, and to incorporate rules governing operations in bankers' acceptances in its authorization for domestic open market operations or perhaps in separate guidelines. The Board had already decided, on July 3, 1973, that it should revoke Regulation B at such time as the Committee was prepared to make its own instruments self-contained.

The second recommendation, Mr. Broida remarked, was concerned with the substance of the rules describing the kinds of acceptances the Desk was authorized to buy and sell. The present rules, set forth in Regulation B, had not been amended since 1923--when Regulation B was originally issued--and they were badly in need of modernization and liberalization. It was proposed that a staff committee be appointed to develop recommendations to that end for consideration by the Committee. Once the Committee was prepared to approve specific rules, the Board and the Committee would be in a position to take concurrent action on their respective Regulations.

In reply to a question by Mr. Daane, Mr. Holmes said he did not believe it would take very long for a staff committee to develop recommendations because the subject had been explored repeatedly by various staff groups during the past 5 or 6 years.

Mr. Coldwell commented that the recommendation in the Secretariat's memorandum that substantive revisions be considered in the rules governing operations in acceptances seemed inconsistent with a statement in the attached memorandum to the Board from the Legal Division that "The proposed changes would be technical and need not entail any change in the actual conduct of open market operations." He asked how those two positions might be reconciled.

Mr. Broida replied that the actions recommended in the Legal Division's memorandum were simply that the Board revoke Regulation B and the Committee delete the reference to Regulation B from its own Regulation. It was now being suggested that the Committee might want to take advantage of the occasion on which those technical changes were made to incorporate such substantive revisions in the rules as it might consider desirable.

Mr. Mitchell asked whether the staff had concluded from the work it had already done that it would be desirable to authorize open market operations in ineligible acceptances.

Mr. Holmes replied that the staff explorations he had had in mind in his earlier comment were concerned not with that type of basic change in the concept underlying System acceptance operations, but rather with means of modernizing the rules by taking account of such events as the development since 1923 of air

and truck freight. Of course, the System had statutory authority to buy and sell ineligible acceptances, and the staff committee might have recommendations in that area also.

Mr. Mitchell expressed the hope that the report of the staff committee would deal with the subject of ineligible acceptances, so that the FOMC would be in a position to decide whether or not it wanted to authorize operations in them.

Chairman Burns asked whether there was any objection to the Secretariat's recommendations, and none was heard.[1/]

Chairman Burns then noted that a memorandum had been distributed from the Secretariat dated September 11, 1973, and entitled "FOMC meeting schedule for 1974."[2/] He asked Mr. Broida to comment.

Mr. Broida remarked that the tentative schedule recommended for FOMC meetings in 1974 was similar to the schedules the Committee had used in 1972 and 1973. Specifically, it called for 12 monthly meetings, to be held on the third Tuesday of the month except when such timing would result in a conflict

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1/ On September 19, 1973, Committee members were advised that Chairman Burns had designated the following to serve on the staff Committee on Bankers' acceptances: Hilbert G. Swanson and Roy A. Remedios, Assistant Vice Presidents of the Federal Reserve Banks of Chicago and San Francisco, respectively; Frederick R. Dahl and Peter M. Keir of the Board's staff; and Peter D. Sternlight, Deputy Manager of the System Open Market Account (Chairman).

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

with a holiday. The only such conflict in 1974 appeared to be in February; a second-Tuesday meeting date was suggested for that month because the third Tuesday occurred the day after the Washington birthday holiday.

Mr. Daane noted that the schedule of Basle meetings had recently been modified on an experimental basis, and meetings were planned for specific Mondays through mid-1974. While he had not had an opportunity to compare the two schedules, he was concerned about the possibility of conflicts between them.

After some further discussion, there was general agreement with the Chairman's suggestion that the Committee postpone consideration of its 1974 schedule until its next meeting so that that question could be looked into.

Chairman Burns then proposed that the Committee turn to its discussion of the economic situation and outlook and of the appropriate direction that monetary policy should take in the period immediately ahead.

Mr. Mitchell observed that in the latest projections the staff had raised the rate of growth in real GNP through the second quarter of 1974 by about a half of a percentage point; a small recession in growth appeared in prospect for that period. Although there was more uncertainty than earlier about the outlook two to three quarters ahead, if anything the economy had

strengthened. He was not particularly disturbed by the decline in M_1 now estimated for the August-September period in contrast with the earlier expectation of growth at a moderate rate; he attributed the miss either to erratic behavior of the statistics or to errors in estimation of the relationship between the Federal funds rate and growth in the monetary aggregates. However, he was disturbed that all three of the alternative policy courses presented by the staff offered low prospects of achieving the Committee's goals for the aggregates in the period immediately ahead. Nevertheless, he saw no reason in either the economic outlook or in the behavior of the aggregates for the Committee to change its policy stance in a conspicuous way. On the contrary, such a change might be undesirable because of its effects on public psychology.

Mr. Black commented that the choice among the alternative policy courses at the present time was an unusually difficult one. He would prefer the growth rates for the monetary aggregates associated with alternative A, but he recognized the risk Mr. Axilrod had mentioned that the strength of the demand for money might have been underestimated by the staff. Moreover, the rate of growth in RPD's shown under all three alternatives was high. Therefore, he believed--and his view had been reinforced by the staff's answers to the questions he had posed earlier--that the weekly average Federal funds rate should

be held steady in the range of 10 to 11 per cent. The first order of business was to convince the market that the Committee had achieved and would maintain control of the aggregates. Should it appear at some fairly early date that the market had become so convinced, the funds rate might be permitted to decline. Barring unexpected developments, however, he would not want to have the funds rate fall below 9-3/4 per cent in the period until the next meeting.

Mr. Eastburn remarked that the staff had clearly drawn what he believed to be the issue confronting the Committee: whether to start now or to delay the process of returning the monetary aggregates to the desired longer-run growth path that the Committee had adopted at previous meetings. Projections made by his staff suggested that the rates of monetary growth under alternative C would result in a recession in 1974. Even if the Committee were willing to accept that, it was not a practical alternative. As soon as a recession began to develop and unemployment began to rise, pressures would become irresistible to reverse course and generate rapid rates of monetary growth. The resulting stop-and-go policy would be the worst approach of all. A better course would be to aim to return M_1 to the 5-1/4 per cent growth path over a reasonable period of time. Accordingly, he favored the longer-run growth rates and the

funds rate range shown under alternative B. However, he would hope that the rate of growth in M_1 in the September-October period would be higher than the 0 to 2 per cent range shown under B, and therefore he would widen that range to 0 to 4 per cent.

Mr. Francis said he believed that the rate of inflation could be lowered gradually over a period of time lasting, perhaps, for as long as 3 years. The rate of expansion in M_1 had been reduced from about 8 per cent in 1972 to about 5 or 5-1/2 per cent so far in 1973; it would be desirable if monetary expansion remained at about that rate in the balance of 1973 and then in a range of 4 to 5 per cent after the turn of the year. A more substantial decline in the rate of monetary expansion over the rest of 1973 would run some risk of depressing real economic growth and employment. Therefore, he thought the short-run rates of expansion in M_1 specified under all three alternatives were too low. In the case of alternative A, moreover, the low rate of expansion in the remainder of 1973 would be followed by an excessively high rate in the first quarter of next year.

Mr. Francis observed that he favored the longer-run target for M_1 of 4-1/2 per cent that was specified under alternative B. For the September-October period, however, he would prefer M_1 growth at a rate between 3 and 4 per cent. Such a rate would be likely to result in a December level for M_1 of

about $267 billion--the level associated with the longer-run target the Committee had adopted in March. Growth in the first quarter at a rate consistent with the longer-run target would bring the level of M_1 up to about $270 billion in March 1974, which he thought would be desirable. For the operational paragraph of the directive, he preferred the alternative C language.

Mr. Francis added that his concern about the nature of the Federal funds rate constraint was somewhat more acute at the present stage of the business cycle than it was at other times. The effect of the constraint on the behavior of the aggregates was as much a source of concern when it prevented declines in money market rates as when it prevented increases. Because he believed that interest rates were at or near a turning point, he would favor removing the constraint entirely, or at least specifying it in a manner that would not bring about excessive resistance to strong downward pressures on interest rates and, in the process, reduce growth in the aggregates to unduly low rates.

Mr. Balles remarked that he agreed with the view of most forecasters, including those within the System, that a recession next year was not in view and that the most likely course was nothing worse than several quarters of subnormal

growth in real GNP. Of course, the outlook could change if the Committee attempted to prevent a decline in interest rates and, consequently, became too restrictive in terms of rates of growth in the aggregates. The reasons for permitting declines in interest rates were compelling so long as they were consistent with attainment of the Committee's longer-run targets for the aggregates. Declines in market rates would lessen the problem of disintermediation, especially for the nonbank thrift institutions, and would improve the supply of mortgage credit. Political pressures on the System would be reduced.

Continuing, Mr. Balles called attention to a poll taken at a meeting of the National Association of Business Economists--and reported in yesterday's papers--in which 80 per cent of the group had indicated a belief that the System had been doing only a poor to fair job. Whether or not the criticism was justified, it was clear that at the minimum the System had a public relations problem. The critics apparently interpreted the behavior of the aggregates as reflecting a stop-and-go policy. An effort by the Committee now to resist downward pressures in interest rates arising from a downward shift in the demand for money would provide additional evidence in support of that interpretation.

In conclusion, Mr. Balles remarked that the genie of inflation could not be stuffed back into the bottle and that the Committee should not try to compensate for the damage that had already been done; he agreed with Mr. Gramley that monetary policy could do little at this stage to slow down the rise in prices in the immediate future without incurring enormous risks. Therefore, considering the quarterly-average rates of M_1 growth he had cited earlier, he would favor A as the alternative which would most closely restore M_1 to the desired growth path. If that involved a substantial decline in the funds rate, he would not be disturbed.

Mr. Daane commented that he agreed with Mr. Mitchell's view of the appropriate posture for monetary policy at the present time. The decision facing the Committee was a difficult one; as he had emphasized at the last meeting, there were expectational dimensions to the decision that went beyond the behavior of the monetary aggregates. Monetary policy was concerned with more than just the aggregates, and their behavior was not the only indicator of whether or not policy had been or would be stop-and-go. He agreed with the staff's assessment of the economic situation, but expectational influences with respect to both inflation and the course of economic activity were such that a change in the posture of policy at present

could materially affect economic developments in the short run. Therefore, he hoped that the Committee would maintain the current policy stance, maintaining money and credit conditions in such a way as to avoid any indication of a change in posture. At this juncture he hoped that the Committee would not play the numbers game with respect to the aggregates but instead would place primary emphasis on money and credit conditions, particularly in the light of the market's sensitivities. At times in the past the Committee had suggested that the Manager make errors either on the side of ease or on the side of tightness to indicate the Committee's shading of emphasis in its policy posture. In this case his own emphasis on an unchanged policy posture as reflected in market conditions could be illustrated by an injunction to the Manager not to make any errors at all.

Mr. Debs said that, as others had noted, the Committee had some difficult decisions to make today. In approaching them, he had found it useful to focus separately on two issues: first, the substantive decision on the direction of policy, and second, the impression that would be made on markets, both at home and abroad.

As for the question of substance, Mr. Debs continued, there did not appear to be any new developments of sufficient weight to move the Committee off its present course. Inflation was still the predominant problem, and inflationary expectations showed no sign of abating. Except for housing, economic activity continued to be strong. Demand pressures were acute and capacity was strained. With respect to the aggregates, there obviously had been a marked slowdown in M_1 growth in recent weeks. Such a slowdown had been the aim of policy over the past

few months, however, and in that sense it was a welcome development. In any case, whatever its implications, experience had shown that the Committee could not put too much weight on the figures for 1 or 2 months. And while M_1 was slowing, bank credit was still expanding more rapidly than was desirable, despite all of the System's efforts to slow it down.

Apart from the Committee's basic decision on the direction of policy, Mr. Debs observed, it was also important to give special consideration at the present time to the impressions that would be conveyed to the markets and to the public in general. The financial markets seemed to be almost obsessed with the idea that the System might be about to change direction, and the public was watching for any signs of change in the System's resolve. The Board's action on marginal reserve requirements, followed by the Chairman's strong statements on the need to maintain firm restraint, had served to discourage that kind of questioning and expectation. Yet, as indicated in the markets in the last couple of days, the salutary effects of those clear signals from the System might only be temporary. In any case, any sign now of a relaxation by the System might add fuel to the fires and might undo much of the progress that had been made toward bringing money and credit under control and toward improving the balance of payments.

Viewing those considerations together, Mr. Debs remarked, he would favor maintaining the present direction of policy, which was reflected in the 2-month ranges of alternative C, together with the associated language for the directive. He

would have no objections, however, to adopting the longer-term targets of alternative B. He would also like to suggest that the Committee consider adding a 2-month range of tolerance for the bank credit proxy. The Committee now had a long-term target for the proxy, and it might be timely and useful, particularly in view of the System's current concern with bank credit, to specify a short-term range as well. If that were done, a range of about 4 to 8 per cent might be appropriate.

Mr. Debs added that another factor that required consideration in terms of its impression on the market was the range established for the Federal funds rate; under alternative C, it would remain 10 to 11 per cent, as in the latest intermeeting period. In normal circumstances that range would be appropriate. However, with the rate presently at about 10-3/4 per cent, there was a risk that if it were to move substantially below 10-1/2 per cent, expectations of an easing in System policy would be rekindled. Such a development would be unfortunate and probably unnecessary. Accordingly, it might be desirable to set the floor for the range at about 10-1/2 per cent or to have an understanding--as the Committee had had at times in the past--that the Desk would not go much below the level of 10-1/2 per cent without further consultation. A decision could then be made on the basis of all of the evidence available at that time, including the state of the markets. In

any case, once there was somewhat stronger evidence that the expected economic slowdown was closer, and that monetary expansion and inflationary expectations were more under control, the System should be prepared to move promptly. In his view, however, that time had not arrived.

Chairman Burns observed that a monetary authority that attended to its responsibilities could not be popular, particularly at a time when interest rates were rising as they had been and when thrift institutions and the housing industry were in real difficulty. If there were convincing signs that fiscal policy would take more of the burden of over-all restraint, he would be among the first to urge a significant easing of monetary policy. But there were no such signs; on the contrary, there were some indications of a dangerous step-up in Federal spending. On the other hand, he could not agree with Mr. Debs' view, if he understood it correctly, that the Committee should delay any appreciable easing in policy until it had convincing evidence of a reduction in inflationary expectations and a reduction in the rate of advance in the price level. If the Committee waited that long the economy might be in serious trouble.

The Chairman noted that some members had referred to a stop-and-go policy. In his view, the Committee had not

pursued a stop-and-go policy with regard to the monetary aggregates. Rates of growth of the aggregates had fluctuated in the short run, but they had not done so because of shifts in the Committee's objectives. The fact was that the System's short-run control over the monetary aggregates was very limited; that was true not only of the System but of all central banks. If, however, there was a significant decline in interest rates--particularly the Federal funds rate, which the System did directly influence--that would be interpreted by many observers as reflecting a stop-and-go policy, especially if it were followed by an accelerated expansion in bank credit.

Concerning the present situation, Chairman Burns said the System, in his view, had gone as far as it should in a restrictive direction and had established its position. He believed a majority of Board members shared that view, as was suggested by the Board's decision in turning down some recent applications for an increase in the discount rate. As to the monetary aggregates, he would not be disturbed by declines or very small increases for perhaps another month; after all, the money created in preceding months was still available to carry economic activity forward. However, he would not want to see the aggregates behave in that fashion for many more months. His own position on policy was close to that of Mr. Mitchell,

with a slight modification--he would favor a small tilt in the Federal funds rate in an easing direction. The funds rate had been in the upper half of the 10 to 11 per cent range established at the last meeting, and in the weeks immediately ahead he would prefer to have it zigzag around 10-1/2 per cent and not reach 11 per cent. The market itself was likely to produce such behavior, and perhaps the Manager could help it now and then.

When the economy was still strong and inflation was running wild, the Chairman observed, it was important to have one group in the Government maintaining a restrictive policy rather than yielding to strong pressures to ease. The Federal Reserve would serve the country well if it continued for a little while longer to pursue the policies that had caused it to be unpopular.

Mr. Coldwell remarked that a downturn in economic activity did not yet appear in prospect, that credit was still being generated at too high a rate, and that inflationary pressures remained strong. Consequently, he would not favor an early shift in policy. There were risks associated with a policy move in either direction. However, the risk of overkill--which obviously would become greater at some time--did not appear high enough now to warrant a change in policy. Apart from its

implications for economic developments in the United States, a downturn in interest rates at present might regenerate problems for the value of the dollar in exchange markets. Moreover, he had observed a tendency in recent years to make changes in policy in the August-September period that later were regretted. In his view, the figures for M_1 were being distorted by the changes that had been effected in Regulation Q, and therefore, they did not provide the basis for a change in policy.

Continuing, Mr. Coldwell said that while following a fairly stable policy, the System should not resist all declines in interest rates. He would favor a range for the Federal funds rate of 9-3/4 to 10-3/4 per cent. Of the three alternatives for the operational paragraph of the directive proposed by the staff, C came closest to expressing his preference for policy. His first choice, however, would be a paragraph reading as follows: "To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to maintain the current degree of restraint with the objective of reducing the rate of growth of bank credit and RPD's."

Mr. Mayo commented that a restrictive monetary policy was called for both because of the economic situation itself and because of the state of expectations; he agreed with those

who argued that it was too early to ease. The view held at the Chicago Bank was that the economic outlook was even stronger than that presented in the green book. Like Chairman Burns, he believed that fiscal policy would prove to be disappointing, and that was another reason for wanting to avoid a significant relaxation of the System's restrictive monetary policy at the present time. There was no chance at all that an increase in taxes could be enacted in time to affect the rate of inflation in the near term. On the expenditure side, the Congress already had exceeded the Administration's budget requests in some areas, although those overruns had not yet been reflected in the figures on actual expenditures used by the staff.

With respect to the policy alternatives today, Mr. Mayo said he would reject both alternatives A and C. The former would represent too sharp a shift in the direction of easing while the latter perhaps would prove to be a classic case of overstaying a position of restraint and of using monetary policy inflexibly. It would be possible to modify the objective for the funds rate somewhat without changing the 10 to 11 per cent range of tolerance adopted by the Committee at the previous meeting; the rate could be moved down into the area of 10-1/4 to 10-1/2 per cent in line with a posture of having reached a plateau of restraint but not of having turned abruptly toward ease. He

would favor the language of alternative B and the longer-run targets shown under that alternative, including a 4-1/2 per cent growth rate for M_1. It was a source of considerable satisfaction to him that growth in the bank credit proxy had been reduced from quarter to quarter this year, and if the alternative B targets were achieved, growth in the proxy would slow further in the fourth quarter of the current year and the first quarter of next year. With respect to the behavior of M_1 in the short run, another month of no growth would not be a cause for worry, in part because at present M_1 was not an accurate indicator of developments; M_3 might be a desirable indicator if the available statistics were better. He would widen the range for RPD's to 14-1/2 to 17-1/2 per cent from the 15 to 17 per cent range specified under alternative B.

Mr. Mayo added that there was likely to be a huge addition to the demand for bank credit in the next month or so because transportation difficulties would cause 1973 harvests to pile up in grain elevators and on farms. Given the large rise in prices of grains over the past year, needs for credit to carry the stocks might be two to three times the needs of a year earlier. Although the System had to be careful that bank credit was not used for inventory speculation, it had to do what it could to assure that credit would be available to carry the stocks of

grains. Loan demands to carry on cattle feeding operations also would be somewhat stronger than a year ago because of the sharp rise in prices.

Mr. Coldwell remarked that bankers in his District expected credit demands for the purpose of financing storage of grains to be about four times as large as they had been a year earlier.

Mr. Francis commented that credit needs to finance storage of crops in the southern part of the St. Louis District also might be four times greater than those of a year earlier. The larger banks viewed the problem with particular concern because they had developed a program of selling such loans to smaller banks after the latter's agricultural production loans had been repaid, but this year--with the Federal funds rate at 10-1/2 to 11 per cent--the smaller banks might be tempted to sell Federal funds as an alternative to buying the loans.

Mr. Morris observed that monetary policy had been severely restrictive in the past 5 or 6 weeks, and the effects of that stance would not appear in current economic indicators for another month or two. However, the signs of severe monetary restraint were beginning to appear in bank credit. Growth in business loans at weekly reporting member banks was leveling off, and for the first time in this period, a substantial amount

of corporate short-term financing was being diverted to the commercial paper market. In the mortgage market, the degree of restraint was probably as great as it had ever been.

Chairman Burns said he would agree that mortgage markets probably were as tight as they had ever been at this stage of the cycle except for the support being provided to the market by Government-sponsored corporations, which was much greater now than in either 1966 or 1969.

Continuing, Mr. Morris remarked that in his judgment the time had come to probe in the direction of a less restrictive monetary policy. He agreed with the view that the Committee could not wait to begin to ease until the projected weakening in economic activity was clearly confirmed by incoming data. However, the probing in the period until the next meeting of the Committee should not be so great that it would be difficult to reverse. Therefore, he would not support alternative A, which represented a major policy move. He favored alternative B, but he agreed with Mr. Eastburn that the September-October range for M_1 should be 0 to 4 per cent rather than 0 to 2 per cent on the ground that operations should not become restrictive if growth in M_1 reached a rate of 2 per cent. Also, he would instruct the Manager to begin to move the funds rate down to 10-1/2 per cent, and in order to make clear that the probing

was to begin without waiting for further weakness to appear in data for the aggregates, he would set the upper limit of the range for the funds rate at 10-1/2 per cent.

Mr. Morris added that he was disturbed by the emphasis that some members of the Committee placed on the effects of policy actions on market expectations. Monetary policy was the only flexible instrument of stabilization policy that the Government had, and it should not be frozen because of a fear of market reactions to a policy change. The Committee should not surrender the flexibility of monetary policy that was so important when the economy was approaching a turning point.

Mr. Sheehan remarked that one aspect of the discussion so far today reminded him of a young man with whom he had gone through flight training in the Navy. While everyone else wanted to be a carrier pilot and fly single-engine planes, that young man decided to become a multi-engine pilot. He wanted to fly the four-engine seaplanes because the throttle settings were limited to on and off; the airplane climbed at 95 knots, it cruised at 95 knots, and it came down at 95 knots. It seemed to him that in much of today's discussion, the conduct of monetary policy was being viewed in on-and-off terms. In his judgment the task of stabilizing the economy was analogous to steering a heavy ship; in both cases smooth movements of the controls were desirable.

Mr. Sheehan agreed that there was considerable underlying strength in the economy. However, he was struck by statements in the red book[1/] that, for the first time, called attention to developing weakness--perhaps it would be better to say reduced strength--in some areas. The commercial banks were really restraining loan growth, and the effects of the present degree of monetary restriction would become more obvious in the next 4 to 8 weeks. The question, therefore, was how soon should the Committee begin to move toward ease. Looking backward, monetary restraint had been imposed progressively over a period beginning in the second quarter of 1972. For a considerable part of that period the tightening had been gradual, but over the past 3 months it had intensified. At this point, he would not suggest a dramatic reduction in the degree of restraint, but he would move down somewhat from the peak because he was concerned about the risk that the monetary aggregates would grow too slowly. Over the 3 months from May to August M_1 had expanded at an annual rate of 5.4 per cent. For the first 9 months of 1973, accepting the staff projection of zero growth in September, the rate was 4.4 per cent--quite a bit slower, although in his judgment not too slow. For the period ahead, he favored the longer-run growth rates of alternative B. However, he would widen the September-October ranges

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

for both RPD's and M_1 in the manner that had been suggested. For the funds rate, he preferred an upper limit of 10-1/2 per cent, and he would drop the lower limit to 9 per cent.

Mr. Holland commented that the idea of adjusting the degree of pressure the Committee was placing on the financial system struck him as good. He did not think the kind of adjustment he had in mind should be described as an easing action, because in his view a continuation of current reserve and money market conditions would entail a steady increase in the pressure being exerted on economic activity. That would be a mistake. The time had come to allow the funds rate to edge down somewhat as a natural counterpart to a policy that aimed to achieve expansion in reserves consistent with a moderate rate of growth in the monetary aggregates. At times like the present, policymakers often were tempted to postpone action in order to be a little more certain of their ground, but such delays tended to widen the oscillations in both interest rates and the growth rates of the aggregates. This was a time to exploit the flexibility of monetary policy that Mr. Morris had mentioned, even if that involved risks of false starts.

Mr. Holland said he would like to see the aggregates grow along the paths specified under alternative B. As had been noted earlier, growth in M_1 was being depressed at present

by a stock adjustment following the recent changes in Regulation Q. However, the analytical problem posed by the stock adjustment was not solved by adding to M_1 the estimated amount of funds transferred from demand deposits to some form of time deposits. That was so because the transfer of funds into time and savings deposits--especially into the longer-maturity deposits that were subject to penalties for premature withdrawal--resulted to a degree in a reduction in liquidity in the economy and represented, therefore, some additional monetary restraint. Moreover, the indications of slowing were not confined to M_1; they were evident in M_2 and M_3 and even in the bank credit proxy. To him, that provided confirmation of the wisdom of pursuing a policy course along the lines of alternative B. However, he agreed with Mr. Eastburn's suggestion to raise the top of the September-October range for M_1 by 2 percentage points, making it 0 to 4 per cent, and he also would add 1 percentage point to the upper end of the range for M_2, making it 5 to 8 per cent; he would not favor any tightening if the aggregates appeared to be growing at rates within those ranges. He would like to see the funds rate drift down, and he hoped that the Committee would be prepared to see it decline toward 10 per cent if the aggregates behaved as the specifications suggested they would.

On the subject of expectations, Mr. Holland remarked that the Federal funds rate was not the only financial variable

of relevance. In particular, the behavior of the monetary aggregates was likely to lead to conclusions that their growth rates were under control, and that in turn would produce expectations of a softening in interest rates. He thought the System should not attempt to maintain the funds rate at its current level as the softening spread through the structure of short-term rates, as he expected it would.

Mr. Bucher said he would associate himself with the views expressed by Messrs. Francis, Sheehan, Eastburn, and Morris. The red book offered clear indications of some slowing in economic expansion, and particular segments of the economy--notably housing--were experiencing serious problems. While he agreed that not much support was likely to be forthcoming from fiscal policy, the limits to which monetary policy could be pressed had to be kept in mind. Growth in the monetary aggregates had slowed, and the full effects of the existing degree of monetary restraint were still in the future. In his view, this was not a time for the Committee to depart from its basic long-term strategy with respect to the aggregates; if they were allowed to deviate too far from the desired longer-term paths, an overreaction later might generate serious problems. Moreover, the Committee should not be unduly sensitive to market reactions since that, in effect, would mean that the market was determining policy.

Mr. Bucher observed that he liked Mr. Morris' notion of probing toward ease. With regard to specifications, he would widen the 2-month range for M_1 of alternative B to 0 to 4 per cent, and he would assume that the range for RPD's would have to be adjusted accordingly. Like Mr. Morris, he would set the upper limit for the funds rate constraint at 10-1/2 per cent; he would set the lower limit at 9 per cent and would instruct the Desk to move the rate toward that limit.

Mr. MacLaury said he would associate himself with Mr. Morris and others who had endorsed the latter's views. While a few months of slow growth in the aggregates should not be a source of concern, the question--as Mr. Eastburn had said--was at what point the Committee should begin to shift direction. In his view, that time had come; he agreed with those who advocated a policy of probing toward ease. At this point, the best indicator of policy was the Federal funds rate, and he would set the range at 9-3/4 to 10-3/4 per cent. In his earlier comments on operations in the period since the last meeting, he had suggested that the Desk should have allowed the funds rate to decline more than it did, and he would urge that in the coming period the rate should be allowed to move down within the range he had mentioned if the behavior of the aggregates so indicated. Rate changes of 1/4 of a percentage

point per week were not excessive, although they had a greater impact at some times than at others. He agreed that market expectations should not be allowed to determine policy.

Mr. Winn said he thought that the economy might be stronger than had been projected, although that view might be a consequence of the fact that cyclical developments in his District tended to lag those in the nation as a whole. The directors of the Cleveland Bank were very optimistic about prospects for the year ahead; business directors reported that their projected capital expenditures were being raised substantially and were far in excess of their estimates of cash flow. Given their view of the situation, they had even considered proposing an increase of 1 to 2 percentage points in the discount rate.

At the same time, Mr. Winn continued, there were some indications of a slowing in economic activity. Therefore, he would maintain the present posture of monetary policy for at least another month while economic prospects for the autumn became more clear. He would favor widening the short-term ranges for the aggregates under alternative B and would retain the present 10 to 11 per cent range for the funds rate.

Mr. Clay observed that he agreed with everything that Mr. Mitchell had said, but he arrived at a more liberal policy

conclusion. The outlook for inflation and real growth appeared to be little changed from when the long-term growth path of M_1 had been reconfirmed 2 months earlier. That long-term growth path would still appear to be the most judicious way of minimizing the employment impact of current anti-inflationary policies. Achievement of a fourth-quarter rate of growth of 6.5 per cent in M_1, which was necessary to hit the long-run target at the end of December, would probably necessitate immediate and large decreases in the Federal funds rate. However, pursuit of such a policy would be wrong. In order to avoid the disruptive effect such a policy might have on the credit markets, it would be appropriate now to extend the horizon of the longer-run target through the first quarter of 1974. Extended over a longer period of time, the approach to the longer-run growth path might be accomplished with only a moderate easing in the funds rate over the weeks ahead. He favored the longer-run targets for the aggregates specified under alternative A. However, he preferred the range for the Federal funds rate specified under alternative B as the best approach in attempting to achieve the longer-run targets without having an immediate market impact. He also favored the language of alternative B.

Mr. Fossum said he agreed with those who advocated a steady policy posture. At the present time, he would place

more emphasis on bank credit and money market rates and less on M_1 and the other aggregates. He would maintain the Federal funds rate at about 10-1/2 per cent; therefore, he favored alternative C. Because he would deemphasize the aggregates, however, he preferred the directive language that Mr. Coldwell had proposed.

Chairman Burns said it might be useful at this point to have more general expressions of sentiment regarding Mr. Coldwell's suggestion for the directive.

Mr. Mitchell remarked that while he had no objection to Mr. Coldwell's proposal on grounds of principle, he might note that one of the objectives it described--that of reducing the rate of growth in RPD's--was inconsistent with specifications shown in the blue book. The RPD growth rate was currently estimated at about 12 per cent for the August-September period, whereas the lowest of the three alternative ranges shown for September-October--that of alternative C--was 14-1/2 to 16-1/2 per cent.

Mr. Daane said he also had noticed that difficulty. He would favor Mr. Coldwell's suggestion if the final clause, relating to growth rate objectives, were deleted, so that the paragraph would end with the statement that "...the Committee seeks to maintain the current degree of restraint."

In the course of further discussion it was determined that a majority was not in favor of such an operational paragraph.

In reply to a question by Mr. Mitchell, Mr. Axilrod noted that the reasons for expecting high RPD growth rates in the September-October period--ranging around 16 per cent under the three alternatives--were discussed in the blue book. Briefly, about half of the expected growth was attributable to the expected behavior of CD's and nondeposit sources of funds--including about 3-1/2 percentage points reflecting the two recent increases in marginal reserve requirements--and 4-1/2 points were attributable to the expected behavior of other time and savings deposits. Only about 2 points were due to anticipated growth of demand deposits; the balance reflected expected changes in excess reserves.

Mr. Mitchell remarked that the particular relationships shown in the blue book between growth rates for RPD's and the Federal funds rate--for example, the alternative B ranges of 15 to 17 per cent for the former and 9-1/4 to 11 per cent for the latter--were evidently contingent on assumptions regarding time deposit behavior which at best were questionable. If the assumptions were wrong and the ranges adopted turned out to be inconsistent, the Manager could concentrate on attaining one or the other, or he could ask for further instructions, perhaps in a special meeting. It was not clear to him just how the Manager would be expected to proceed.

Chairman Burns observed that the Manager would be expected to notify him (the Chairman) promptly if significant conflicts emerged among the Committee's various objectives, as he had done on a number of occasions in the past. The procedures that had been evolved for issuing new instructions on such occasions had worked rather well and would be available for use. Whether or not it would appear desirable for the Committee to hold a special meeting would depend on circumstances.

The Chairman then said he would like to offer a specific suggestion for consideration by the Committee. He proposed adopting a directive consisting of the general paragraphs as drafted by the staff and alternative B for the operational paragraph. It would be understood that that directive would be interpreted in accordance with the following specifications. The longer-run targets would be those shown under alternative B--namely, growth rates for the fourth and first quarters combined for M_1, M_2, and the credit proxy of 4-1/2, 6, and 6-1/2 per cent, respectively. The associated ranges for the September-October period would be 15 to 18 per cent for RPD's, 0 to 4 per cent for M_1, and 5 to 8 per cent for M_2. The range for the weekly average Federal funds rate during the intermeeting period would be 9-3/4 to 10-3/4 per cent.

In reply to a question by Mr. Morris, Chairman Burns said he had intended those specifications to be consistent with his earlier suggestion of a tilt in the funds rate at an early date to a range around 10-1/2 per cent.

Mr. Daane asked whether the Chairman intended the proposed 9-3/4 to 10-3/4 per cent range for the funds rate to be permissive, or whether he would expect the Manager to generate a downdrift within that range.

Chairman Burns said he had intended that range to be a permissive one.

Mr. Francis asked whether the Chairman would contemplate communicating with the Committee before the next meeting if it appeared necessary to lower the range for the funds rate, as he had done following other meetings when increases had been necessary.

Chairman Burns replied that he would, assuming the behavior of the aggregates indicated that consultation was needed.

In response to a question by Mr. Daane, Mr. Holmes expressed the view that a decline in the funds rate to 10 per cent or less would have a strong impact on market expectations.

Mr. Holland observed that in considering instructions to the Manager he leaned toward the activist side; he would favor instructing the latter to reduce the weekly average funds rate by one-quarter point, to 10-1/2 per cent, and to make subsequent operating decisions on the basis of unfolding developments.

Messrs. Mayo and Bucher said they shared Mr. Holland's view, and the Chairman remarked that that was the sense of his earlier comment.

Mr. Debs observed that an instruction to zigzag around 10-1/2 per cent, as the Chairman had proposed earlier, would seem to be an effective way of probing.

Chairman Burns replied that he would not want to limit the instructions to such a statement since doing so would, in effect, be telling the Desk to ignore developments with respect to the monetary aggregates.

Mr. Daane asked whether it would be possible to probe toward ease in any meaningful way without arousing undesirable market expectations.

Mr. Holmes replied that various kinds of developments could arouse such expectations; on a number of recent occasions market attitudes had moved strongly in one direction only to reverse themselves completely the very next day.

Mr. Mayo commented that it might be possible to carry out at least part of the desired probing by not resisting any tendencies that might emerge from time to time for the money market to ease slightly on its own.

Mr. Daane said he would prefer such an approach.

Chairman Burns remarked that any probing actions by the Desk in the first few days following a meeting would almost certainly lead to misinterpretations of the Committee's intentions and to a sharp market reaction. That the Desk should not seek changes in conditions promptly after a meeting was, in his judgment, a good general rule, although the Committee might want to deviate from it under special circumstances.

Mr. Holmes said that, in any event, it appeared from projections that money market rates would be under some upward pressures from market forces in the next few days and that the System would be supplying reserves. As he interpreted the Committee's wishes, the Desk should seek reserve conditions consistent with a Federal funds rate around the current 10-3/4 per cent level during the rest of this week. It should try to ease the rate down to 10-1/2 per cent during the following week--although it might not be successful in that initial attempt--and should make subsequent operating decisions on the basis of market reactions and incoming data on the aggregates.

Mr. Daane remarked that he could go along with the Manager's interpretation, and Mr. Debs made a similar statement.

Mr. Holland said he would favor having the Desk operate a little more aggressively than Mr. Daane preferred, and Messrs. Balles, Bucher, Mayo, Morris, and Sheehan agreed.

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

The information reviewed at this meeting suggests that growth in real output of goods and services, which slowed in the second quarter from the exceptionally rapid pace of the two preceding quarters, will be moderate in the third quarter. Although nonfarm employment rose sharply in August, the average gain in recent months has been smaller than earlier and the unemployment rate has changed little at a level somewhat below 5 per cent. The exceptionally rapid advance in prices was interrupted in July by the temporary freeze imposed in mid-June. However, farm and food prices surged after mid-July--when the freeze was lifted on most such products--and despite later appreciable declines, they remained far above pre-freeze levels. The U.S. merchandise trade balance improved further in July, and net foreign purchases of U.S. stocks increased. In recent weeks exchange rates for the dollar against most foreign currencies have changed little on balance after strengthening in the first half of August, and the balance of payments has been in surplus on an official settlements basis.

The narrowly defined money stock, which had increased moderately in July, declined somewhat in August. The more broadly defined money stock continued to expand as a result of net inflows at banks of consumer-type time deposits. Nonbank thrift institutions experienced net deposit outflows in the July-August period. Expansion in bank credit has continued at a substantial pace. On September 7 the Federal Reserve announced an increase from 8 to 11 per cent in marginal reserve requirements on large-denomination CD's. Interest rates on long-term market securities declined from early August to early September, partly because of growing expectations that the maximum degree of monetary restraint had been reached. Later, however, such expectations weakened and some long-term rates turned up. Short-term rates generally remained under upward pressure in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to abatement of inflationary pressures, a sustainable rate of advance in economic activity, and continued progress toward equilibrium in the country's balance of payments.

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Secretary's note: The specifications agreed upon by the Committee, in the form distributed following the meeting, are appended to this memorandum as Attachment B.

It was agreed that the next meeting of the Committee would be held on October 16, 1973, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida

Secretary

ATTACHMENT A

September 17, 1973

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 18, 1973

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that growth in real output of goods and services, which slowed in the second quarter from the exceptionally rapid pace of the two preceding quarters, will be moderate in the third quarter. Although nonfarm employment rose sharply in August, the average gain in recent months has been smaller than earlier and the unemployment rate has changed little at a level somewhat below 5 per cent. The exceptionally rapid advance in prices was interrupted in July by the temporary freeze imposed in mid-June. However, farm and food prices surged after mid-July--when the freeze was lifted on most such products--and despite later appreciable declines, they remained far above pre-freeze levels. The U.S. merchandise trade balance improved further in July, and net foreign purchases of U.S. stocks increased. In recent weeks exchange rates for the dollar against most foreign currencies have changed little on balance after strengthening in the first half of August, and the balance of payments has been in surplus on an official settlements basis.

The narrowly defined money stock, which had increased moderately in July, declined somewhat in August. The more broadly defined money stock continued to expand as a result of net inflows at banks of consumer-type time deposits. Nonbank thrift institutions experienced net deposit outflows in the July-August period. Expansion in bank credit has continued at a substantial pace. On September 7 the Federal Reserve announced an increase from 8 to 11 per cent in marginal reserve requirements on large-denomination CD's. Interest rates on long-term market securities declined from early August to early September, partly because of growing expectations that the maximum degree of monetary restraint had been reached. Later, however, such expectations weakened and some long-term rates turned up. Short-term rates generally remained under upward pressure in recent weeks.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to abatement of inflationary pressures, a sustainable rate of advance in economic activity, and continued progress toward equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat more rapid growth in monetary aggregates over the months ahead than has occurred on average thus far this year.

Alternative B

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with slower growth in monetary aggregates over the months ahead than has occurred on average thus far this year.

ATTACHMENT B

September 18, 1973

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 9/18/73)
A. Longer-run targets (SAAR): (fourth and first quarters combined)	M_1	4-1/2%
	M_2	6 %
	Proxy	6-1/2%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (September-October average):		15 to 18%
2. Ranges of tolerance for monetary aggregates (September-October average):	M_1	0 to 4%
	M_2	5 to 8%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		9-3/4 to 10-3/4%
4. Federal funds rate to be moved in an orderly way within range of toleration		
5. Other considerations: account to be taken of international and domestic financial market developments.		

C. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, 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.