

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, December 15, 1970, at 9:30 a.m.

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

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

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

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

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

Messrs. Wernick and Williams, Advisers,
Division of Research and Statistics,
Board of Governors

Mr. Keir, Associate Adviser, Division of
Research and Statistics, Board of
Governors

Mr. Bryant, Associate Adviser, Division of
International Finance, Board of
Governors

Mr. Wendel, Chief, Government Finance
Section, Division of Research and
Statistics, Board of Governors

Miss Ormsby, Special Assistant, Office of
the Secretary, Board of Governors

Miss Eaton, Open Market Secretariat Assistant,
Office of the Secretary, Board of
Governors

Miss Orr, Secretary, Office of the Secretary,
Board of Governors

Mr. MacDonald, First Vice President, Federal
Reserve Bank of Cleveland

Messrs. Eisenmenger, Link, Taylor, and Tow,
Senior Vice Presidents, Federal Reserve
Banks of Boston, New York, Atlanta, and
Kansas City, respectively

Messrs. Bodner, Snellings, Scheld, and Green,
Vice Presidents, Federal Reserve Banks
of New York, Richmond, Chicago, and
Dallas, respectively

Messrs. Gustus and Kareken, Economic Advisers,
Federal Reserve Banks of Philadelphia
and Minneapolis, respectively

Mr. Sandberg, Securities Trading Officer,
Federal Reserve Bank of New York

At Chairman Burns' suggestion the participants in the meeting stood for a moment in silence in memory of W. Braddock Hickman, President of the Federal Reserve Bank of Cleveland and member of the Committee, who had died on November 28, 1970.

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By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on November 17, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on November 17, 1970, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period November 17 through December 9, 1970, and a supplemental report covering the period December 10 through 14, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Bodner said that over the period since the last meeting of the Committee there had been a pronounced shift in rates in the foreign exchange and Euro-dollar markets. The exchange rate for the dollar had strengthened in most European centers, at the same time as Euro-dollar rates had rebounded significantly. The two developments were, of course, directly related as there was no evidence of any recent shift in the underlying U.S. balance of payments. What had been happening, in fact, seemed to represent primarily year-end adjustments affecting the Euro-dollar market, reinforced by the response of U.S. banks to the Board's recent measures affecting their Euro-dollar liabilities and by a decline in interest rates in some

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continental centers. The early part of the period beginning in mid-November witnessed a continuation of the developments of the first half of that month, as Euro-dollar rates declined rapidly, especially at the short end of the maturity spectrum. U.S. banks were rapidly reducing their liabilities to their European branches and those funds were being absorbed at progressively lower rates by banks and firms on the continent. Belgium, France, and Italy benefited to some extent from those inflows, but Germany continued to attract the bulk of the available funds, taking in about \$1 billion between November 17 and 24, even after a cut in the discount and Lombard rates of the German Federal Bank.

Mr. Bodner noted that despite those substantial flows of funds and the rapid movement of Euro-dollar rates, Mr. Coombs had indicated at the previous two meetings of the Committee that he expected it would be possible to get by the year end without significant financing problems. That judgment was based not only on an assessment of the behavior of the central banks which might acquire funds coming out of the Euro-dollar market, but also on the anticipation that the usual year-end adjustments would soon begin to affect the market. That pattern began to emerge toward the end of November and had continued since then. Short-term Euro-dollar rates had moved up substantially; for example, the one-month rate rose from 5-3/4 per cent in late November to 7-1/8 per cent in early December and it went as high as 8-1/2 per

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cent this morning. The rise in other rates was somewhat less dramatic but nevertheless significant.

Those rate developments of course reflected a variety of factors, Mr. Bodner said. However, the principal factors at the moment seemed clearly to be the increased demands made by subsidiaries of U.S. corporations that were preparing for repatriation of funds for balance of payments purposes, coupled with the sudden curtailment of repayments by U.S. banks in the face of the Board's announcement on November 30 of regulatory actions affecting their Euro-dollar borrowings. In fact, very heavy bidding for funds by U.S. banks was reported from London this morning. The statement made by the Board of Governors in its announcement seemed for the moment to have more or less frozen the U.S. banks' positions in the Euro-dollar market. In the face of the usual December withdrawal of funds by U.S. corporate subsidiaries and increased borrowings by those subsidiaries, the current reluctance of U.S. banks to see their Euro-dollar liabilities reduced had put strong upward pressure on the market. As a result, not only had funds stopped flowing into continental centers, but there had been a marked improvement in dollar exchange rates, reflecting some reversal of earlier flows. Moreover, that tendency had been aided by an easing of demands from a number of continental centers and by deliberate interest rate reductions on the part of several central banks.

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It seemed very unlikely that anything would happen over the next couple of weeks to change that pattern significantly, Mr. Bodner remarked. On the other hand, it appeared equally unlikely that that situation could persist very long into the new year with the present disparity between interest rates in this country and in the Euro-dollar market, or even with some decline in Euro-dollar rates. Clearly, the U.S. banks had taken very much to heart the warning both implicit and explicit in the Board's action, but the cost to them of doing so was considerable.

Mr. Bodner reported that the change in the exchange market picture in the latter part of November and early December that accompanied the shifts on the Euro-dollar market ran pretty much across the board. In Germany after the very large inflows he had mentioned earlier some short-term capital outflows developed and the mark exchange rate fell to par. That movement in the mark was aided by the second recent cut in the discount rate of the German Federal Bank. During the past few days the mark had been just above par.

In the case of sterling, Mr. Bodner continued, the change in the picture was reflected not so much in the market rate-- which had remained just below \$2.39--as in a cessation of the inflow of funds to the British reserves. The earlier inflows enabled the Bank of England fully to repay its swap drawings on the System and to prepay the December installment of the Sterling

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Balances Arrangement. Since then, however, the exchange market had been about in equilibrium as some short-term outflows to the Euro-dollar market had offset the continuing substantial current account surplus. Concern about inflation in the United Kingdom had been growing in the face of large wage settlements and continued strife over unresolved wage claims. In that connection, the decision of the electricity workers to return to normal work was a hopeful sign although it remained to be seen what the final outcome would be. In any event, after the temporary aberration of last spring--when the money supply had gotten very badly out of hand during a period of heavy sales of government securities by the clearing banks--the Bank of England did seem to have the monetary situation under firm control again and the government was showing increasing signs of willingness to stand up to exorbitant wage demands. Some real success in that area could go a long way toward furthering confidence in sterling.

As he had mentioned earlier, Mr. Bodner said, there had been further flows of funds into Belgium at the beginning of the period. In fact, the System had to draw another \$70 million equivalent of Belgian francs to provide cover for those inflows. Those drawings brought the System's commitments up to \$320 million. There had been no further inflows, however, and last week the Belgian National Bank cut its discount rate by 1/2 point to 6-1/2 per cent, primarily in order to avoid further capital inflows.

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That cut, coupled with the rise in Euro-dollar rates, had resulted in a significant easing of the Belgian franc rate over the last week. A roughly similar pattern prevailed in most of the other markets except that in no case were further System swap drawings required.

Mr. Bodner noted that the Italian lira had been the one exception to the general pattern in the exchange market. The performance of the lira had continued relatively strong, although there had been some slippage in the rate in recent days. Following the settlement of some major political difficulties, the Italians had been able to take in dollars in modest amounts and the over-all political situation looked somewhat more secure now than it had in some time. There was no telling, of course, how long that would last, and the Bank of Italy people remained quite cautious in their assessment of the outlook for next year.

With respect to the gold situation, Mr. Bodner continued, there was little new. The free market price had remained generally at either side of \$37-1/2 with modest activity. South Africa had continued to finance its deficit through sales of gold directly to the International Monetary Fund. On the official side, the United States had engaged in a large volume of gold transactions recently. However, almost all of them were related to increased quota payments to the IMF, and Treasury sales had been mitigated under the agreed procedures. All of those sales had been expected with the

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exception of that currently being arranged with the Bank of France. The French gold subscription was about \$128 million and the Treasury had been under the impression that, like other European countries, the French planned to use their own gold. However, they had decided to purchase from the United States the gold to meet that payment. There would, of course, be a corresponding sale from the Fund to the Treasury under the mitigation procedures. This past weekend Mr. Coombs had had extensive discussions with representatives of the Bank of France regarding that transaction, and he had been assured that it did not reflect in any way a revival of the old French policy on gold. On the contrary, the representatives had confidentially indicated to Mr. Coombs that the Bank of France expected the dollar inflow to taper off in 1971 but that, in any case, it planned to hold a very substantial dollar position over and above its outstanding obligations to the IMF.

By unanimous vote, the System open market transactions in foreign currencies during the period November 17 through December 14, 1970, were approved, ratified, and confirmed.

Mr. Bodner reported that four System drawings on the Belgian National Bank, totaling \$80 million, would mature between December 30 and January 22. Of these, one would be maturing for the first time and the others for the second time. The Belgians had indicated that they now thought that a significant part of the inflow during the past few months--insofar as it reflected a

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running down of inventories in anticipation of an increase in the value added tax--might prove reversible early in the new year. At the same time they did not believe it would prove possible to reverse all of the \$320 million in drawings now outstanding, and had proposed that \$155 million of those drawings be funded through the use of special drawing rights and an IMF drawing. The Treasury had already agreed to the use of \$110 million of SDR's for the purpose, but discussions of the timing of a possible IMF drawing were still under way. He anticipated that it would be necessary to renew the \$30 million System drawing maturing for the first time on January 21. While he hoped that the other three drawings maturing soon--which had already been renewed once--would be repaid prior to maturity, timing problems related to the Treasury's IMF drawing might necessitate a second renewal of the \$20 million drawing maturing on December 30.

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

Mr. Bodner then reported that a \$50 million System drawing on the Netherlands Bank would mature for the first time on December 28, 1970, and a \$30 million drawing on that Bank would mature for the second time on January 22, 1971. Discussions had already begun with the Netherlands Bank regarding the repayment of those swaps but it might be necessary to renew them before such arrangements were finally worked out.

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Possible renewal of the two System drawings on Netherlands Bank was noted without objection.

Mr. Bodner reported that two System drawings on the Swiss National Bank, totaling \$300 million, would mature for the first time on December 31, 1970. He recommended renewal of those drawings.

Renewal of the two drawings on Swiss National Bank was noted without objection.

Mr. Bodner then noted that his remaining recommendations related to renewal of System swap arrangements with the central banks of the Common Market countries and Canada.

Chairman Burns suggested that the Committee postpone consideration of those recommendations until later in the meeting.

The Chairman then invited Mr. Daane to report on developments at the December Basle meeting from which the latter had just returned.

Mr. Daane said he would touch only on the highlights of the meeting, which he had attended along with Mr. Coombs. First, comments made in private conversations during the weekend tended to corroborate the report he had made to the Committee following the November Basle meeting to the effect that the time table of the European Economic Community for moving toward economic and monetary integration had experienced a setback. He had not yet heard what had happened at the meeting of EEC Finance Ministers

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today, but the expectation had been that no agreement on the matter would be reached. Nor was there any real expectation of an agreement very early in 1971. Moreover, if and when the EEC countries agreed on some plan for narrowing the margins of fluctuations in their exchange rates against each other, a considerable period--perhaps as much as three months--would be required to put a plan into effect. The timing the EEC people now seemed to expect was an agreement by spring on a plan that would be in effect by midyear. However, there was some feeling that even such a time table might be too optimistic.

Second, Mr. Daane observed, in the go-round at the Governors' session on Sunday afternoon there were general expressions of appreciation for the steps the Board had taken as of December 1 to moderate the reflow of Euro-dollars. Indeed, the feeling might have been too strong that the Federal Reserve had solved the problem, at least for a considerable period of time. At the same session a great deal of continuing concern was voiced regarding wage, price, and cost developments in the individual countries. Governor O'Brien was more pessimistic about the outlook for wages and prices in Britain leading to a loss in competitiveness than had been the U.K. representative at the Working Party 3 meeting, on which he presumed Mr. Solomon would report. Nevertheless, like the U.K. representative at WP-3, Governor O'Brien noted that the recent performance of Britain's current account had been better than

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expected. He thought it likely that in 1971 Britain's surplus on current account would be substantial, although not so large as the roughly \$1.5 billion surplus now in prospect for 1970. The Governor also reported that Britain had made real progress in debt repayment and was now preparing to make a repayment under the first Basle agreement.

Mr. Daane remarked that President Klasen of the German Federal Bank had commented on the cessation of inflows to Germany following the two successive reductions in the Federal Bank's discount rate and the Federal Reserve action on Euro-dollars. He had expressed uncertainty regarding the extent to which the cessation was related to year-end developments, as opposed to factors that could be expected to continue operating after the end of the year. Most significantly, he had noted the real risk of a recession developing in Germany. Governor Wormser had drawn an interesting distinction between the attitudes of the French Government on the one hand, and public opinion on the other, regarding the domestic economic situation. The government was generally satisfied, although not complacent, about the performance of the economy. The public, however, was very much concerned about the possibilities of stagnation and recession. President Stopper of the Swiss National Bank had complimented the System on its Euro-dollar move. He had also said he had been advised that a law recently enacted in the United States--Public Law 91-508, the so-called "Bank Secrecy Act"--

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represented a first step toward exchange controls. That comment apparently reflected a misconception of the objective of the legislation, and he (Mr. Daane) and Mr. Coombs had attempted to clarify the matter.

Finally, Mr. Daane said, the discussion at the Sunday dinner session focused entirely on questions raised by President Zijlstra of the Netherlands Bank: Had a world-wide recession begun, against the background of developments in the United States? If so, how long would it last? Had the recession been sparked by a profit squeeze that was exerting an adverse effect on investment? There was a surprising amount of acceptance around the table of Dr. Zijlstra's thesis that the first and third of those questions should be answered affirmatively. To suggest the flavor of the discussion, he might note a few of the individual Governors' views. Governor O'Brien had reported that investment in Britain was still rising but at a considerably reduced rate. President Klasen said he believed that new orders for investment goods in Germany would decline by about 20 per cent in 1971, and he reiterated that there was a real risk of recession. The Japanese representative expected a much smaller rise in investment next year, reflecting some profit squeeze. The Swedes were quite pessimistic. The French anticipated some rise in investment in 1971, but not nearly so much as had been forecast. The Dutch quite clearly expected to share in a general downturn and were concerned about the time lag in inducing a

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turn-around in investment. And Dr. Stopper had said that while the Swiss would not be in a position to contribute to a general recession they might well import one.

Mr. Mitchell asked how Mr. Daane thought the Europeans would reconcile their concern over recession--which presumably would call for an easing of monetary policy--with their satisfaction over the Board's Euro-dollar action, which would tend to keep European interest rates higher than otherwise.

Mr. Daane replied that the apparent inconsistency in those views might be explained to some extent on timing grounds. For example, the Germans were foreseeing another discount rate cut, but probably not until March. In part, however, the views might be irreconcilable. Considering the Board's Euro-dollar action by itself, the Europeans were pleased primarily because it demonstrated that the Federal Reserve was aware of the problem and was willing to take action.

Chairman Burns then asked Mr. Solomon to report on recent international developments.

Mr. Solomon said he would first comment briefly on the recent Paris meeting of Working Party 3 and then turn to developments with respect to Euro-dollar flows. Part of the discussion at the WP-3 meeting involved a review of the over-all balance of payments situation in 1970 and the prospects for 1971. The conclusion was that, apart from short-term capital flows, there had

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been a general movement in 1970 in the direction of equilibrium of payments flows--as reflected in improvements in the current-account positions of the United States, the United Kingdom, and France, and the reductions in the surpluses of Germany and Japan. That movement, however, had been overwhelmed by the reflows of Euro-dollars from the United States to European markets and then to the reserves of European central banks.

As at Basle, Mr. Solomon continued, gratification was expressed at the WP-3 meeting regarding the Federal Reserve Euro-dollar measures to which Mr. Daane had referred. A report by the German representative--to the effect that during the past three months German companies had borrowed as much from the Euro-dollar market as they had from German banks--suggested just how important the return flows from the United States were to European monetary authorities.

Finally, Mr. Solomon said, he had received the strong impression that market interest rates in Germany would come down after the turn of the year--even though, as Mr. Daane had suggested, the discount rate might not be reduced again for a few months.

Mr. Solomon then made the following statement:

I propose to focus this morning on the actual and potential reflow of Euro-dollars from U.S. banks.

There were distributed to the Committee last week copies of a memorandum that assesses the size of the potential outflow and discusses the problems that

would be created if such a large volume of dollars flowed into European central banks in the months ahead.^{1/}

The essence of the problem is that as monetary policy has eased here in the United States, interest rates have remained high in Europe, where the efforts to control demand inflation lag behind ours. Interest rates in most European money markets are now above Euro-dollar rates and European demands for funds in the Euro-dollar market have remained strong. As a result, even though American banks have repaid about \$5 billion of their Euro-dollar liabilities this year, Euro-dollar rates still remain significantly above U.S. money market rates and U.S. banks continue to have an incentive to repay these costly liabilities.

Although several large banks have hesitated to give up any of their reserve-free bases, the present cost of holding these bases is 1-1/2 to 2 per cent higher than rates in the United States on liabilities of comparable maturity. This cost appears high to banks in relation to the potential benefits of preserving a reserve-free Euro-dollar position.

It is against this background that the Board has been examining various proposals to deal with the Euro-dollar repayments by American banks. A major objective of such proposals is to provide scope for Federal Reserve policy to respond to domestic needs without seriously adverse effects on the external position of the dollar.

There are two broad categories of proposals. One type would provide the banks with a financial inducement to hold on to their Euro-dollar liabilities. This could be done either by reducing the cost to banks of holding the liabilities or increasing the benefit of having reserve-free bases. The other type of proposal would absorb the dollars that flow back to the market so as to keep them out of the hands of foreign central banks. This could be done, for example, via Treasury borrowing in the Euro-dollar market.

The Board's actions announced on November 30 were of the first type--designed to encourage banks to hold on to their Euro-dollar liabilities. The increase in

^{1/} The memorandum, from Mr. Solomon to the Board of Governors, was dated November 17, 1970, and entitled "Dealing with the Overhang of Euro-dollar Liabilities: Laissez-faire vs. Taking Action to Discourage Outflows." A copy has been placed in the Committee's files.

the marginal reserve requirement on borrowings above the reserve-free base was a way of telling banks that the reserve-free base may have greater value in the future than they might have assumed. The action applying to so-called "3 per cent banks" was designed to introduce an automatic downward adjustment to the reserve-free bases of these banks too. Up to November 30, only banks operating on a historical base stood to lose the base as they reduced liabilities. One result is that smaller banks have an incentive to borrow Euro-dollars in order to establish a base during the 4-week computation period ending January 20.

Since the Board's announcement, the repayment of Euro-dollar liabilities has apparently slowed and Euro-dollar rates have risen. This increase in Euro-dollar rates is not surprising. Any action by the Federal Reserve to slow bank repayments would have that effect, other things being equal. The purpose of such action is to reduce the magnitude of the reflows of funds to the Euro-dollar market, not to affect the rate differential.

What will happen over the next two weeks is highly uncertain in view of the usual year-end pressures in European markets and the action by American corporations in repatriating large amounts of funds in compliance with the Commerce Department program.

After year-end, European money market rates are likely to decline and so are Euro-dollar rates. But European rates are not likely to fall to the level of U.S. money market rates for some time and, meanwhile, U.S. rates could fall further. In these circumstances, American banks are unlikely to be deterred for long by the Board's recent actions from continuing to let their Euro-dollar liabilities run off.

Mr. Maisel referred to Mr. Solomon's comment that any Federal Reserve action to slow repayments of Euro-dollars would raise Euro-dollar interest rates, "other things being equal." He asked whether the qualification did not beg the question; if other things were actually equal, there would seem to be no problem.

Mr. Solomon replied that the "other things" he had had in mind were foreign monetary policies and the strength of demands for

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funds abroad. What he was saying, in effect, was that with a given demand any reduction in supply would tend to raise prices. If other things were equal in the sense he meant, it seemed to him that there would be two persisting problems: the deficit in the U.S. balance of payments, and the undermining of European monetary policies--which were still relatively stringent--by reflows of Euro-dollars from the United States. Perhaps one could argue that the latter would represent an advantage rather than a problem, if he believed that restrictive monetary policies abroad were inappropriate in the light of the risks of recession.

Mr. Mitchell commented that Euro-dollar rates would undoubtedly have risen to some extent as a result of year-end seasonal pressures even if the Board had not acted. He gathered that Mr. Solomon thought the System need not be concerned about the rise that had occurred--perhaps because he expected Euro-dollar rates to come down again in January.

Mr. Solomon replied that if the Federal Reserve had any grounds for concern it was not so much with the level of the Euro-dollar rates per se but with the volume of Euro-dollar flows to Europe.

Mr. Mitchell noted the possibility that U.S. banks would resume heavy repayments of Euro-dollar liabilities in January, and in the process drive Euro-dollar rates down to the point at which there would be less incentive for them to continue the process. He suggested that the situation might then prove to be no different

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from what it would have been had the Board not taken any action in the area.

Mr. Sherrill expressed the view that, if the Board had not acted and U.S. banks had continued to make heavy repayments in December, the situation in January would have been very different from that which he now expected.

Chairman Burns then invited Mr. Brimmer to comment on the results of a study the Reserve Banks had made of export credits.

Mr. Brimmer noted that, as the Committee would recall, the Board had asked the Federal Reserve Banks to make a study of the effects on exports of the 1970 voluntary foreign credit restraint program. Of the 170 banks reporting to the Federal Reserve, responses to a questionnaire had now been received from 107. In all, seven banks reported that they had turned down a total of 11 requests for export credit as a result of the workings of the VFCR program during the first 10 months of the year. The amounts involved added to \$2-3/4 million, in comparison with U.S. exports of \$40 billion during that period. From information the banks had supplied it appeared that not over \$1 million of exports had been lost because banks had turned down credit requests. Even in those cases, it appeared that the banks had reasons other than the VFCR for refusing the requests. Further information was being sought from the exporters the banks had identified as well as from other exporters.

Mr. Brimmer added that a written report on the results of the study would be distributed to the Committee soon.

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

Mr. Partee made the following statement concerning economic developments:

This is the traditional season for being jolly, and we at the Board are participating with the various Christmas festivities scheduled for this week. But so far as the major subject of this meeting is concerned--the economic situation--there is little to be jolly about. True, the strike at General Motors has ended and a shutdown of the railroads has been averted once again, at least temporarily. Despite the certainty of a large temporary rebound in autos, however, the basic situation remains that industrial production is depressed, retail sales sluggish, unemployment high, and wage rate pressures continuing to push upwards on prices. The red book^{1/} makes gloomy reading, with virtually no District reporting increased activity other than in residential construction, and with a clear consensus that only a very moderate recovery in over-all activity is in prospect for the next year. The capsule view reported in the summary, which I share, is that "the majority of respondents look for inadequate (economic) growth and inadequate moderation of inflation."

Although the effects of the GM strike had become quite pervasive by November, it seems to me that the major statistical indicators have continued to show weaknesses that go well beyond strike-related influences. Thus, initial claims for unemployment insurance remained very large throughout November and into early December, after allowance for

^{1/} The report, "Current Economic Conditions by District," prepared for the Committee by the staff.

seasonal changes, and insured unemployment was at or close to its high for the year. Industrial production in November declined another 0.6 per cent, none of which was due directly to autos and only part of which reflected further reductions in output at supplier industries. Retail sales also have continued relatively poor. Excluding autos, the preliminary figures are that sales showed very little rise in November following a good October increase. Unit sales of GM's auto competitors failed to benefit during the strike period, and they may even have dropped off a bit, after seasonal allowance, from the levels of last summer. And general merchandise sales in the first week of December--the first full week of the all-important Christmas season--were no larger in dollar terms than in the same period a year ago.

As the green book^{1/} comments, consumer demand appears to have been even more sluggish than we had been projecting earlier. Perhaps spending will pick up soon--the sharp rebound in the stock market in recent weeks, for example, may help make the consumer more optimistic. But other indicators of sentiment are not favorable. Recent consumer surveys have reported a deepening of pessimism. The University of Michigan survey, in particular, shows the poorest confidence index since that measure has been calculated, reflecting concern about both continued inflation and future unemployment. Our staff economic projection for 1971, if realized, would not be likely to assuage consumer worry on either count. That projection incorporates a rise in consumer spending fully in line with estimated growth in disposable income, which I think is about as optimistic as one can be at this point in time.

The latest Commerce-SEC plant and equipment survey suggests a bit more strength in business outlays than we had expected. Thus, spending intentions are reported for the first half of 1971 as equal to the current half year and 2 per cent above the first half of 1970 in current dollar terms. We have adjusted slightly upward our projections of

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

capital spending because of these survey findings, although we still show a decline of one-half per cent in dollar outlays for the year as a whole compared with 1970. The continuing quarter-to-quarter decline in the anticipated spending of manufacturers shown by the survey, and the large current drop in physical output of business equipment--now off 12 per cent from the 1969 peak--suggest caution in interpreting the over-all survey results. Further shortfalls in capital spending below planned levels seem to me a very real possibility.

In short, I can see no development of note over the past month that would make one more bullish about the economy. Housing starts have done well, but this was expected. State and local bond financing has continued in large volume, promising a pickup in construction by this sector also; but, meanwhile, increasing reports of short-falls in revenues at the State level cast some doubt on the presumed uptrend in current operating budgets. We have increased our estimates of Federal expenditures for calendar 1971 by \$3 billion, mainly reflecting larger transfer payments stemming from growing welfare and unemployment rolls, and this is reflected in somewhat stronger estimates of consumer spending on nondurable goods and services. But the prospect remains much as before--a temporary strike-make-up surge in activity in the first quarter, followed by slower expansion over the remainder of the year. The increases projected in GNP, though substantial in dollar terms, result in real growth at only about a 2-1/2 per cent annual rate from the third quarter of 1970 through the fourth quarter of 1971. This would be insufficient to keep the unemployment rate from trending upward.

Although there are differences in degree and pattern of expected GNP expansion, I have not found major departures from the Board staff's projection in the great majority of private business forecasts I have seen or in the views of my research associates at the Federal Reserve Banks. That is, nearly everyone is in agreement that there will be economic expansion from this point on, but there is also general agreement that the expansion in prospect

fails to match even our long-run growth potential--much less take up any of the current slack--over the next several quarters. The model that has received press attention calling for real growth over the next year at an 8 per cent annual rate seems to be in the nature of a rather amorphous target rather than a specific projection of expected economic developments.

Given the general agreement that unsatisfactory economic recovery is in prospect, it seems to me that more expansive public economic policies are clearly indicated. There has been a good deal of talk about a more expansive budget, with numbers around \$231 billion for fiscal 1972 mentioned in the press; indeed, this level of spending is not inconsistent with our current projections for calendar 1971. This would provide some stimulus, but not nearly enough. We have done some experimenting with our econometric model to see what the effects of alternative policies might prove to be. These indicate that, even if the fiscal 1972 budget were to be as high as \$235 billion, real GNP by mid-1972 would be less than 1 per cent higher than if a \$230 billion spending level prevailed.

Faster rates of monetary growth would make a bigger difference. Again according to the model, a rate of expansion in the money supply over the next year of 7 per cent, rather than 5 per cent, would bring about financial conditions adding nearly 2 per cent to total real output by mid-1972. Combining this easing in monetary policy with the higher budget figure would raise real GNP by 2-1/2 per cent and reduce the unemployment rate by 1 percentage point from what it otherwise would be in an extension of our present judgmental projection. Since substantial resource underutilization would persist throughout the period, the more liberal policies would be expected to have only a minor effect on the GNP price deflator--raising it 0.2 per cent by mid-1972, according to the model.

The course of economic expansion described by the more liberal policy alternative--the major feature of which is a quickening of growth in late

1971 and early 1972--is not an undesirable one, given the current and prospective levels of unutilized labor and capital resources. If the basic staff economic projection is roughly correct, it would produce real growth over the quarters ahead a little in excess of our long-term growth potential. If the staff projection proves too low, real growth might then be sufficient to eat into our present residual of unused capacity. And if the staff projection is too high, the liberalized policy would have proven timely in combating a worsening economic situation. I therefore urge the Committee's adoption of alternative C of the draft directives,^{1/} with a view to achieving the financial conditions consistent with a 7 per cent growth rate in money until or unless evidence develops that this is generating unwarranted expansion in economic conditions and prospects.

Mr. Axilrod made the following statement concerning financial developments:

The sharp drop in corporate and municipal bond yields, the easing of bank lending terms to businesses and consumers, and the sustained price rise in the stock market have been the most notable financial market developments since the last meeting of the Committee. All of these events should work, sooner or later, toward resuscitating the pace of economic activity. The improving stock market is, of course, found in the leading cyclical indicators, and has a noticeable, positive effect on consumption in the Federal Reserve-MIT model. But the rise in stock prices could be somewhat premature, when compared with profits prospects. And, with stock prices still about 20 per cent below late-1968 highs, uncertainty about long-term capital values is likely to dilute consumption effects.

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

With respect to the drop in bond yields and the easing of bank lending terms, these do not appear to have gone far enough yet to encourage a reasonably rapid, noninflationary economic recovery. Yields on new high-grade corporate bonds, at around 7-3/4 per cent, are still about 85 basis points above their 1969 lows. They are also about 3 full percentage points above their early-1966 levels, which was about the time when long-term interest rates, following several years of relative stability, started on their marked upward course.

I am not necessarily suggesting that the current economy is so weak, and inflationary expectations so muted, that early-1966 levels of bond yields are now required to reinvigorate plant and equipment and other expenditures based on credit. But in view of the current outlook, I would feel no hesitancy about seeing corporate bond yields drop back over the relatively near term to, say, at least their 1969 lows.

A further significant decline in long-term rates would help stimulate mortgage demand, and would likely also encourage spending by State and local governmental units, many of whom have become quite cost-conscious as their tax base has come under pressure. In addition, it does not seem desirable for corporations to be incurring sizable amounts of long-term, relatively high-cost debt when the outlook for return on business capital investment is as uncertain as at present and when efforts need to be made to reduce the cost-push elements of inflation.

There are a number of considerations working toward lower long-term interest rates. Some do represent factors that may lead to a stimulation of borrowing demands and economic activity. Others, however, merely reflect sluggishness of the economy or changed attitudes. For example, a decline in long-term market interest rates because inflationary expectations wane should not necessarily be considered as stimulative, since the waning of inflation may well also be accompanied by dampened expectations as to future money income and profits and hence by a reduction in willingness to borrow commensurate with the decline in interest rates.

More stimulative would be a reduction of long-term market interest rates resulting from a reduction in bank lending rates and aggressive efforts by banks to attract business borrowers. Business loan demand at banks has been exceptionally weak over the past three months--with such loans outstanding at banks and their closely-related affiliates declining at a 10 per cent annual rate. This, together with the reduced cost of time deposit and other funds, has been moving banks toward more active efforts to seek out borrowers. While business may be stimulated in some degree by such efforts, and by an associated decline in long-term market interest rates, it should be pointed out that a good part of the decline in bank and other interest rates is still a reflection of business weakness. To be truly stimulative, monetary policy has, of course, to push interest rates down more rapidly than is consonant with moderating credit demands and a declining return on capital.

No doubt, some of the recent decline in interest rates--both short- and long-term--reflects the cumulative effects of the moderately expansive monetary policy since the first of the year. The narrowly-defined money supply has continued to rise recently, but the increase over October and November has been at a reduced annual rate of a little less than 3 per cent, as compared with a growth rate of almost 6 per cent over the first nine months of the year. There have been signs in late November and early December of a more rapid rise in the making, however.

The reserves provided through open market operations, of course, support more than the demand deposit component of the money supply. Nevertheless, it is difficult to judge the current intensity of monetary actions by the rate of increase in reserves--which has been extremely low of late--because of shifts in the mix of deposits, including Euro-dollars, and the lagged reserve requirement. Looking through reserves to the bank liabilities they support, we can see that growth in the adjusted credit proxy slowed to about a 4-1/2 per cent annual rate in October and November. It was, of course, to be expected that the

rate of growth in the adjusted proxy would slow markedly from the 17 per cent third-quarter rate, when a restructuring of credit and asset flows took place. However, the rate of growth in October and November was also below the historically rather modest 6-1/2 per cent second-quarter rate. Still, as with money supply, data for late November and early December suggest that a much more rapid growth in the adjusted credit proxy is in the making for December.

From the viewpoint of the behavior of the adjusted credit proxy, or of the narrowly-defined money supply, it would appear that the recent decline in interest rates to an extent reflects weakness in the economy and in credit demands rather than an easing in monetary policy this fall. But the rapid long-term rate declines of the past week or two do appear to coincide with the development of a more rapid expansion of bank credit and money.

In view of the relatively weak economic outlook-- apart from the projected first-quarter post-strike bulge--further significant declines in long-term interest rates seem desirable. Such declines should have a dimension reflective of encouragement from monetary policy--i.e., associated with reasonably rapid expansion in money and bank credit--and not simply reflective of economic weakness. With this in mind, I would agree with Mr. Partee that the aggregate specifications of alternative C seem desirable at this point. It would not disturb me much if temporary, short-run credit demands that might be associated with post-strike economic activity led to money and short-term market conditions somewhat tighter than those indicated in that alternative. In that case, though, I would take every opportunity to purchase coupon issues, and would purchase some in any event, to encourage further long-term interest rate declines.

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

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the period November 17 through December 9, 1970, and a supplemental report covering the period December 10 through 14, 1970. Copies of both reports have been placed in the files of the Committee.

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

Credit market conditions eased dramatically in the interval since the last Committee meeting, with the 1/4 point cuts in the prime rate and in the discount rate reinforcing optimistic market expectations about interest rates. The continued sluggishness of the economy, the weakness of loan demand, the ease with which banks and thrift institutions could attract deposits, and the widespread belief that monetary policy would be devoted to assuring growth in the money supply all contributed to the money and capital market rally.

As the written reports to the Committee indicate, interest rates in all maturity sectors declined sharply, with long-term rates--which had declined only modestly earlier--leading the parade, despite a heavy calendar of corporate and municipal issues. Short-term interest rates also continued to decline, with average rates of 4.78 and 4.79 per cent established for three- and six-month Treasury bills in yesterday's regular bill auction, down 51 and 62 basis points, respectively, from those set in the auction just before the last Committee meeting.

Looking ahead, most market participants feel that a further decline of long-term rates is in store, but there is some disagreement as to how much. At the moment, the usual seasonal lull in corporate and municipal bond new-issue activity is approaching, and the general expectation is that, while the corporate calendar for the first quarter of 1971 may build up, it will not reach the scale characteristic of recent months. There is some concern in the market about the implications of reported Administration proposals for a very rapid build-up in the economy for the degree of further monetary easing

that might be forthcoming. Recent speeches by the Chairman and Vice Chairman of this Committee, however, have tended to reassure the market that the Federal Reserve in restoring economic growth has not forgotten the risks of restimulating inflationary expectations.

Until late in the period it appeared that, while the directive's goal of easier credit market conditions was being achieved, money supply growth was lagging behind the reduced 4 per cent growth rate that the Committee reluctantly adopted at the last meeting. Recent estimates, however, indicate that money supply grew more rapidly in November and early December than earlier anticipated, and could reach 5 per cent for the fourth quarter--a level that appeared unlikely of achievement at the time of the last meeting. At the same time, bank credit--reflecting the aggressive portfolio investment policy being followed by banks and the ease with which they have been acquiring time deposits--has expanded much more rapidly than anticipated. Bank credit in December is now expected to grow at a 12 to 17 per cent annual rate rather than the 6.5 per cent blue book^{1/} path presented at the last meeting. One factor in the recent rapid expansion of bank credit is the slowdown in Euro-dollar repayments by U.S. banks since the Board's December 1 change in Regulation M. At the moment, most banks appear to have decided--in many cases reluctantly--to hold on to their Euro-dollars for the time being, pending possible further action by the Board that might provide some incentive for maintaining Euro-dollar bases. Given the wide spread between Euro-dollar and domestic rates, this is a costly operation for the banks, and some further decline in Euro-dollar holdings appears likely unless the spread narrows after the turn of the year.

In trying to keep the money supply growing in line with the Committee's desires, open market operations were used to get the Federal funds rate down to the lower end of the 5 to 5-3/4 per cent range discussed at the last meeting. In the statement week ended December 9, in fact, the funds rate averaged a shade

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

under 5 per cent despite the fact that--on a Wednesday-to-Wednesday basis--the Desk absorbed nearly \$3 billion in reserves through the run-off of outstanding RP's and through short-term matched sale-purchase transactions. Operations have been handicapped to some extent by bank patterns of reserve management that have been rather hard to fathom recently. In the December 9 week, for example, banks tended to build up a large volume of excess reserves over the weekend, with the result that the Federal funds market was firm before the weekend and excessively easy late in the week. In this statement week, in contrast, the Federal funds market was quite easy before the weekend despite a projected very deep net borrowed reserve position for the banking system that suggested we should be providing reserves in some volume. With the Federal funds rate below 5 per cent until late Friday, we refrained from supplying reserves in order not to signal to the market a greater sense of ease than the Committee intended, recognizing that we might have to do some scrambling to provide reserves before the week is out. Yesterday, the funds market firmed up somewhat and we supplied over \$1 billion of reserves, largely through repurchase agreements.

Incidentally, I might note in passing that net borrowed reserve statistics--for those who still follow them--are currently a quite misleading indicator of monetary ease. The bulk of the borrowing at the discount window recently, as you know, has been accounted for by special emergency borrowing by two banks. Borrowing by other banks on some days has been as low as it probably ever has been. If this special borrowing were treated as a separate source of reserve supply for the banks involved, as appears reasonable, and not as normal borrowing, we would have been showing free reserves in 5 out of the last 6 weeks, in amounts ranging from \$125 to \$250 million, rather than net borrowed reserves.

The Committee has before it a number of directive choices provided in the blue book, differing mainly in growth rates for money over the months ahead and the money market conditions expected to be associated with them. As the blue book notes, and as recent experience has indicated, it has proved difficult to specify in

advance the growth rate in M_1 that will be associated with any given set of money market conditions--and beyond that--what the impact will be on the broader spectrum of interest rates encompassed in credit market conditions. Much depends on the strength of the expected growth in demand for money and credit in the months ahead as GNP recovers from the General Motors strike. As usual, it would be most helpful for the Desk to have the Committee's views regarding the trade-offs it desires as between the monetary aggregates and interest rates. Moreover, with bank credit currently growing quite rapidly and with other measures of money that include time deposits and other liquidity instruments expanding more rapidly than M_1 , the Committee might want to consider whether these growth rates should somehow be taken into account along with narrowly defined money supply.

I should note that the Government securities market is currently operating under a cloud of uncertainty about insurance coverage. The uncertainty has not yet had a rate impact but could do so if matters do not turn out as well as expected. I will not go into detail, but should note that a number of important meetings involving the Federal Reserve, the Treasury, the insurance companies, the clearing banks, the Government security dealers, and certain Federal agencies have been under way. The problem has arisen because one major insurance company has announced that it is eliminating or reducing its coverage of Government securities after the end of this year. Basically, the hoped-for solution involves (1) maintenance of adequate insurance coverage and of normal custodial and clearing services by money market banks to ensure an efficient market, and (2) a speeded-up implementation of book-entry procedures for Government and agency securities that will reduce--if not eliminate--the problem of the physical movement of securities through the market.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period November 17 through December 14, 1970, were approved, ratified, and confirmed.

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Chairman Burns then called for a general discussion of the economic and financial situation and outlook, noting that questions could be addressed to Messrs. Partee, Axilrod, Solomon, and Holmes during the discussion.

Mr. Francis remarked that, in attempting to reduce the rate of inflation, the System had applied rather mild monetary restraint since early 1969. The rate of growth of money, according to revised data, had been reduced to 5 per cent in the first half of 1969 and then to little growth in the last half, giving a 3 per cent rate for the entire year. From December 1969 to this November money rose at a 5.5 per cent rate.

That restraint had been sufficient to reduce the rate of growth of GNP to about 4 per cent, Mr. Francis continued. Some progress had been made in reducing the rate of inflation, and the stage had been set, if restraint was maintained, to effect a return to relative price stability in about two more years. The costs associated with combating inflation so far had been less than in previous attempts to curb inflation in the postwar period, but they would probably continue for some time. Given the nature of the System's actions over the past two years it appeared to him that the course of the economy in the immediate past and in the near future was as one would expect.

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In response to a question from Mr. Daane, Mr. Solomon said he shared Mr. Partee's assessment of the economic situation and concurred in the latter's recommendation that alternative C be adopted for the directive. He would add, however, that since he was also concerned about adverse short-term capital flows-- which undoubtedly would be accelerated by an easing of domestic monetary policy--he would also recommend that additional selective actions be taken to temper those flows.

Mr. Daane then noted that alternatives B and C of the draft directives described targets for money in terms of the average growth rate in the first three quarters of 1970--alternative B calling for maintenance of that rate and C for somewhat more rapid growth. He asked whether such language would not pinpoint the Committee's target more precisely than usually was done in the directive itself.

Mr. Holmes replied that that was his impression. He noted, however, that during the past year the policy records published along with the directive typically had included information in numerical form on the Committee's quarterly targets for the aggregates.

Mr. Holland observed that there was a quite recent precedent for the kind of formulation used in alternatives B and C. Specifically, the directive adopted on August 18, 1970, had

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called for "somewhat greater growth in money over the months ahead than occurred in the second quarter." He agreed, however, that the directives usually employed more general language.

Mr. Mitchell noted that the behavior of the money supply during coming weeks would be influenced by year-end window-dressing operations and by the expected temporary surge in spending related to the ending of the auto strike. He asked what rates of money growth might be anticipated in December and January if the Committee called for maintenance of present money market conditions, defined as including a Federal funds rate centered on 5 per cent.

Mr. Holmes replied that the analysis in the blue book suggested that, with a 5 per cent funds rate, the growth rate of money might be roughly 9 per cent in December and 8 per cent in January.

In reply to a further question by Mr. Mitchell, Mr. Axilrod said that according to the blue book some tightening of money market conditions might be required if the Committee adopted directive alternative A, which called for growth of money at a 5 per cent rate over the first quarter as a whole. No tightening was foreseen in the blue book if the Committee adopted either B or C, which called for first-quarter money growth rates of 6 and 7 per cent, respectively. It was possible, of course, that the staff

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had underestimated the strength of the expected first-quarter bulge in money demand; if so, even under alternatives B or C it might prove necessary to tighten money market conditions to keep money growth from exceeding the target rate.

Mr. Maisel said he thought none of the alternatives submitted by the staff for the second paragraph of the directive was appropriate. He would prefer language--which might be labeled "alternative C*"--reading as follows:

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and somewhat more rapid growth in money and attendant bank credit expansion over the months ahead, with allowance for temporary shifts in money and credit demands related to the auto strike. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Mr. Maisel went on to say that he would associate his proposed language with the specifications given in the blue book in connection with alternative C. He thought the wording of C* was better than that of C in two respects: It retained the reference of the previous directive to the need to make allowance for temporary shifts in money and credit demands related to the auto strike, and it avoided the reference to the money growth rate in the first three quarters of 1970 in expressing the Committee's current target for money.

Mr. Brimmer noted that alternative D--consisting of the second paragraph of the previous directive, without any wording changes--suffered from neither of the disadvantages Mr. Maisel found in alternative C.

Mr. Maisel observed that he would object to D on another ground--namely, that in his judgment it called for a tightening of monetary policy.

Mr. Daane said he thought there was clear evidence that the major risk with respect to economic activity was on the downside, and he believed that the System should be flexing monetary policy accordingly. As his earlier question implied, he was troubled about the specificity with which targets for money growth were set forth in alternatives B and C, particularly in light of the imprecise character of estimated relationships between money growth and other key variables. The Committee would, of course, want to discuss appropriate growth rates in the monetary aggregates, but he would hope that any references to specific growth rates would be taken as illustrative comments for the guidance of the Manager, and that the Committee would not incorporate a precise money supply target in its directive.

Mr. Coldwell remarked that he shared some of the views already expressed about the problems that lay ahead, but he did not expect stagnation or a decline in activity actually to develop in 1971. Such a situation would be both politically and

economically unacceptable, and moves to offset it undoubtedly would be forthcoming from some branch of the Government. It would be hard for monetary policy alone to deal with many of the problems ahead, including those in the wage-cost area.

Mr. Coldwell thought the Committee should resist the notion that a particular growth rate for money could be translated into some precise level of GNP or employment. On the other hand, there were risks ahead that the Committee should be taking cognizance of today. The Committee had embarked on a course of promoting moderate growth in the monetary aggregates, and money had in fact grown at a 5 or 6 per cent annual rate over the past 11 months. The fact that comments were still being heard about economic stagnation suggested that the time lags in the impact of policy were quite long. Before the Committee decided to accelerate the rate of money growth substantially he would hope it would look ahead to the likely consequences in the fall of 1971 and later--in particular, to the risk that such a course would bring about a resumption of inflationary pressures then. In general, given the lack of precise knowledge about the impact of monetary policy and its lags, he hoped the Committee would not make a drastic move now.

Mr. Mayo commented that the staff's projections were more nearly in line with his own thinking than previously, but they

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were still a little more pessimistic than the projections prepared at the Chicago Reserve Bank. The Chicago projections of total GNP for calendar 1971 were about \$8 billion above those of the Board's staff. That was not a large difference relative to a base of about \$1 trillion, but the composition of the difference had some significance. Also, he was troubled about the Board staff's judgment as to the unemployment rates that were likely to be associated with the projected rates of GNP growth. If those unemployment rates--6.4 per cent for the year 1971 and 6.7 per cent for the fourth quarter--were to be realized, the resultant pressure for easier fiscal and monetary policy would be tremendous. While he agreed with the caveats others had offered today about the lack of precision in statistical relationships, he thought it would be useful to know whether the staff's econometric model indicated that a step-up in the rate of money growth of, say, 1 percentage point would have a greater effect on growth in real GNP than additional Federal expenditures of, say, \$5 billion a year.

Mr. Partee replied that such comparisons were difficult to make because the effect of a given increase in Federal expenditures depended in part on whether it consisted of purchases of goods and services or of transfer payments. Roughly speaking, however, the model suggested that an increase of \$5 billion in Federal expenditures over a period of time would raise GNP about as much as would a step-up of 1 percentage point in the growth rate

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of money. Admittedly, any such statement was subject to a substantial margin of error, but the general orders of magnitude seemed reasonable to him.

Mr. Brimmer referred to Mr. Partee's earlier comment that a step-up in money growth next year from 5 to 7 per cent, combined with an increase of Federal expenditures in fiscal 1972 of \$5 billion, would raise real GNP by 2-1/2 per cent by mid-1972. He asked whether such a policy mix would be expected to lead to a downturn in the unemployment rate by early 1972.

Mr. Partee replied affirmatively. He noted that in the staff's judgmental model the unemployment rate would reach its high for the year of 6.7 per cent in the fourth quarter of 1971. The econometric model--which was the only projection available beyond 1971--showed a somewhat lower unemployment rate at that time. But that rate would be significantly lower still under the more expansive policy assumptions, and it would be dropping fairly sharply in early 1972--to about 5-1/2 per cent in the second quarter of that year.

Mr. Mayo then asked the Manager to comment on how the operations in coupon issues called for by the Committee at its last meeting had worked out and whether he thought it would be desirable to undertake similar operations in the near future.

Mr. Holmes replied that the recent operations had had only a marginal impact on financial markets. The Desk had bought a little less than \$300 million of coupon issues since the previous

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meeting, limiting its purchases to occasions when prices of such issues were not under strong upward pressure. At the times when purchases were made they were carried out rather aggressively. Fortunately, however, they were not interpreted by the market as a new "operation twist;" rather, they were seen as an effort by the System to take advantage of the availability of coupon issues to give a slight downward push to long-term interest rates. He did not think there would be much opportunity in the coming four-week period to buy coupon issues in the normal course of operations, because seasonal forces were expected to be such as to call for absorption of reserves during most of the period.

Mr. Hayes said he would like to make a few comments on the business situation. It was clear that there had been greater weakness in the economy, even apart from the effects of the auto strike, than had seemed likely a few months ago. But because of the difficulties of measuring the manifold secondary effects of the strike, he thought it was impossible to say just what the true state of the economy was at present. Looking ahead, however, he saw some hopeful signs of a strengthening in business activity. He believed that the recent sharp decline in interest rates not only reflected the weakness in the economy but also suggested that the intense liquidity pressures of last summer had been relieved to some extent. The recent advance in stock prices might have some significant effect on consumer confidence; and with the personal saving rate at its current high level there was considerable room for accelerated

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growth in consumer spending. The housing sector was already performing rather well, and the outlook for housing was highly favorable given the marked improvement in the financial situation in recent weeks and the enlarged inflows of savings funds to thrift institutions. There were some signs that mortgage rates were beginning to edge down. It was true that capital spending was not strong, but the evidence did not suggest that a sharp decline was in prospect. Moreover, the third-quarter rise in corporate profits offered some grounds for encouragement with respect to capital spending.

On balance, Mr. Hayes continued, he thought the outlook was for moderate expansion in GNP during 1971. He certainly hoped the expansion would be moderate; an attempt to stimulate sufficient expansion to bring the unemployment rate down to 4 per cent by mid-1972 would involve an extremely high risk of negating past efforts to slow inflation and of creating even worse inflationary pressures than existed a year ago. While he considered the current level of unemployment to be unacceptably high, he doubted that a rate as low as 4 per cent would be reasonably consistent with stable prices over the next few years. The price situation was highly discouraging. The terms of the auto industry settlement were already being reflected in new car prices and, more generally, it appeared that minimal progress had been made in slowing the advance in both consumer and wholesale prices. He remained convinced of the need for some kind of incomes policy.

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Mr. Morris commented that while the staff projections were certainly pessimistic, pessimism seemed to be justified by the economic statistics for the period since July. Nothing had occurred in the last four weeks to cause him to doubt the validity of the projections.

Mr. Morris remarked that staff at the Boston Bank, noting the references in the newspapers to an 8 per cent target for the growth rate of real GNP in 1971, had undertaken the exercise of investigating the monetary and fiscal policies that would be needed to generate growth at such a rate. Working with a Keynesian model, they concluded that a full-employment deficit of \$10 to \$15 billion would be required in the Federal budget for fiscal 1972. The necessary Federal expenditures were estimated as falling in a range of \$243 to \$248 billion--much higher than any figures now being generally discussed. Using a monetarist model, they found that the money supply would have to grow at a 12 per cent annual rate. Those results demonstrated to him the virtual certainty of a considerable margin of slack in the economy in 1971, and the unlikelihood that any of the policy courses the Committee was considering today would result in over-stimulation.

In reply to a question by Mr. Mayo, Mr. Morris said the staff study did not necessarily imply that both a full-employment deficit of \$10 to \$15 billion and a 12 per cent growth rate for money would be required to achieve an 8 per cent growth rate in real GNP. The two analyses that had been made were independent in the sense that

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the Keynesian model did not require specification of any particular money growth rate and under the monetarist model it was assumed that fiscal policy was not important.

Mr. Mitchell commented that a 12 per cent money growth rate might well be required to finance the level of spending that would result if there were in fact a \$15 billion full-employment deficit.

Mr. Morris then noted that at a recent Committee meeting he had observed that a directive setting forth objectives for both interest rates and monetary aggregates might be impossible of fulfillment; if the projections of the inter-relationships between those variables were wrong, the goals specified could be mutually inconsistent. It seemed to him that that situation had arisen in October and November, when the Committee's interest rate objectives had been achieved but the monetary aggregates had fallen well short of the targets. He asked if the Manager agreed with that interpretation.

Mr. Holmes replied that the answer would depend in part on the specific time period considered. In October, for example, it was true that the money supply had grown less than expected--at a rate of about 1 per cent compared with the 4.5 per cent rate anticipated at the time of the October meeting--even though interest rates had come down. On the other hand, November growth, at an estimated 4.5 per cent rate, was a little stronger than the 3.5 per cent rate expected at the November meeting; and it now appeared that the December growth rate would be 9 per cent, compared with about 5 per cent

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expected in mid-November. The large increase being experienced in December was related in part to the declines in interest rates. In part, of course, it reflected the recent statistical revision. In any case, as a result of the December experience money growth over the fourth quarter as a whole evidently would turn out reasonably well.

Mr. Holmes added that a serious operating problem was posed for the Desk by the fact that growth rates for individual months of a quarter could deviate widely from the target path. The problem was whether to make operating decisions mainly in terms of developments in the current month or to permit judgments to be tempered by expectations regarding likely deviations in the following month or months of the quarter.

Mr. Morris asked whether the Manager would have let money market rates drop more rapidly to insure attainment of the targets for the aggregates if the Committee had not set a floor of 5 per cent for the Federal funds rate.

Mr. Holmes said he thought not.

Chairman Burns expressed the view that it was not wholly accurate to say the Committee had set a 5 per cent floor for the funds rate. The Committee had called for a reduction in the funds rate to the extent necessary to attain the goals for the aggregates, with the understanding that the members' views would be quickly ascertained if the funds rate had reached 5 per cent without producing adequate results. In his judgment the growth now

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anticipated for December and the fourth quarter would not have been attained had the Committee not formulated its instructions as precisely as it had.

Mr. Holmes agreed, noting that it was always helpful to the Desk for the Committee to specify the ranges for money market variables that it considered appropriate.

Mr. Galusha said he was deeply troubled about the implications of the staff's projections and thought it was important that the Committee review its long-term objectives at this time. In particular, the Committee should discuss the growth rates in real GNP and the reductions in unemployment that were desirable and attainable.

Personally, Mr. Galusha continued, he was not convinced that the economy had bottomed out. The manufacturers he talked with were still very pessimistic about the first half of 1971, and while they were guardedly optimistic about the second half their reasoning seemed simply to be that "things had to get better." In his judgment, the Committee should concern itself less with the specific growth rates that had been attained for the money supply, and more with such questions as whether the desired results were beginning to appear in the economy, or whether it could be demonstrated that those results would be produced within some given period. His own analysis provided discouraging answers to such questions.

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Mr. Galusha said he suspected that the most important trade-off for the Committee to consider was that between fiscal and monetary policy. He would not be concerned if fiscal policy became moderately expansionary; indeed, he thought that would be a desirable step. At the same time he thought there was a real risk that fiscal policy would become wildly expansionary--particularly if his appraisal of the economic outlook was correct. He would be prepared to accept a growth rate for money for the time being that was somewhat higher than desirable for the longer run if, as he believed, doing so would help avert that kind of fiscal policy.

Mr. Heflin remarked that in his judgment the problems before the Committee today could be reduced to a single issue--the relative weights to be attached to combating unemployment and inflation. All of the members were, of course, sensitive to the current high rate of unemployment and the prospect of even higher rates to come, and all would like to see the economy restored to the highest sustainable growth track. But while the members would agree that the economic situation was not good at present, they also were all uncertain to some extent as to what lay ahead in 1971. His main concern was that the Committee not take any action today that was likely to backfire later.

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With respect to the directive, Mr. Heflin said he wondered whether some of the alternatives that were intended to be expansionary might in fact turn out to be restrictive. He asked how the Manager would interpret alternative D.

Mr. Holmes replied that he would interpret D as reflecting a willingness to accept a first-quarter growth rate in money higher than the 5 per cent rate now expected for the fourth quarter, in allowing for the shifts in demands related to the auto strike. The blue book specifications for that alternative called for concentrating somewhat more than recently on money market conditions themselves. Under those specifications the Federal funds rate would be maintained in a 5 to 5-1/4 per cent range at the outset. Market conditions would be eased if money appeared to be falling below a path consistent with a 5 per cent growth rate for the first quarter, and they would be firmed if it was running above a 7 per cent path.

Mr. Holmes added that a January growth rate of 8 per cent was associated in the blue book with a first-quarter growth rate of 6 per cent. Indeed, under all of the alternatives discussed in the blue book growth rates were expected to be higher in January than in February or March. Thus, if the Committee was willing to accept a January growth rate of about 8 per cent, it would find that rate not inconsistent with any of the various target rates discussed in the blue book for the first quarter--5, 6, or 7 per cent.

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Chairman Burns remarked that he was interested in the extent to which Mr. Holmes had stressed expectations regarding future changes in the money supply in responding to Mr. Heflin's question. He (Chairman Burns) was more inclined to look back to the shortfalls from desirable growth rates that had occurred in October and November. Those shortfalls could be made up, and he thought they should be. More generally, he was inclined to place less weight on projections--which were necessarily uncertain--and more on the actual historical record.

Mr. Axilrod said it might be worth emphasizing that if the Committee adopted alternative D with the blue book specifications Mr. Holmes had just outlined, it would be indicating a willingness to accept a 5 per cent growth rate for money in the first quarter, should that rate happen to develop under prevailing money market conditions.

Mr. Maisel observed that he agreed with the Chairman regarding the need to make up the shortfalls in money growth. In his view the staff's GNP projections portrayed an unsatisfactory economic situation. But if money did not grow relatively rapidly in December and January, not even the unsatisfactory increases projected for GNP were likely to be achieved. Secondly, like Mr. Axilrod he thought it was worth emphasizing that under alternative D money might grow at only a 5 per cent rate in the first quarter. If the Committee adopted D today it would be saying, in effect, that it

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was prepared to accept a 6.7 per cent unemployment rate in the fourth quarter of 1971. It was important for the Committee to advise the Manager that a 5 per cent growth rate for money was no longer considered adequate because it would not achieve the longer-run goals for the economy.

Mr. Daane noted that the specifications for alternative D also provided for accepting a first-quarter growth rate as high as 7 per cent--if that should develop--without tightening money market conditions.

Chairman Burns remarked that it would be better, in his judgment, for the Committee to reach specific decisions on where it wanted to go and how it wanted to get there.

Mr. Mitchell said he thought the present was a good time to avoid any specific target for the money supply because of the many uncertainties regarding the appropriate growth rate in the short run. He would favor instructing the Manager along the lines of the following "alternative E":

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining present money market conditions over the year end. It is expected that the recent rates of growth in money and bank credit will be maintained and may even temporarily accelerate during this period.

Mr. Maisel referred to Mr. Holmes' observation that an 8 per cent growth rate in January would be consistent with any of the blue book alternatives for the first quarter, and noted that

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those various alternatives were associated with different money market conditions in the coming inter-meeting period. In his judgment the Committee should advise the Manager as to what kinds of money market conditions he should seek initially, rather than say it would accept any that were found consistent with 8 per cent growth in money in January.

Mr. Kimbrel said he was convinced that at this juncture--with the strike effects distorting the statistics, with Government outlays expected to rise, with unemployment trends so uncertain, and with inflationary expectations reviving--the best bet was to stick to a moderate and reasonably steady course of policy. In addition to the dim visibility at present, he thought other reasons could be found for holding to a steady course at the present moment. In his judgment the System's experience had suggested that the Federal Reserve simply did not have the tools for a precise fine-tuning of the economy. At present the burden of economic revival rested to a major degree on the private sector, and there was not much that Federal Reserve policy could do except create the climate favorable to those adjustments. For example, the high rate of consumer saving could fall, and the accompanying rise in consumer spending should eventually revive business investment.

Mr. Kimbrel reported that the sentiment last Friday of the Atlanta Bank's board of directors and the sentiment of the directors at its four branch board meetings during the preceding few days was

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almost unanimous in fearing that the Federal Reserve was about to embark on a course that could only guarantee another burst of inflation. He had been fairly successful in the past in convincing the directors that Federal Reserve policy would eventually be effective in reducing inflationary pressures. He found it was becoming harder and harder, if not almost impossible, to convince them that the System was holding a steady course.

Mr. Kimbrel believed it would be desirable for long-term rates to move down further. Consequently, he was gratified to note in the blue book discussion that long-term rates quite possibly could move down further even without declines in short-term rates. Looking further ahead, he would hope the Board might give some consideration to reducing reserve requirements as a means of inducing further declines in long-term rates. Although such a move probably would not be feasible in January, it could be undertaken in late February or March. He would prefer a reduction in requirements against demand rather than time deposits.

Chairman Burns then called for the go-around of comments and views on monetary policy and the directive, beginning with Mr. Hayes. The Chairman added that those members who had not yet had an opportunity to comment on economic conditions might incorporate such comments in their statements.

Mr. Hayes made the following statement:

With business a bit weaker than had been expected a few months ago, and with unemployment somewhat higher, it seems clear that monetary policy should be reasonably

accommodative. On the other hand, we are still making very little demonstrable progress against inflation--which argues for extreme caution to avoid excessive easing. International considerations also argue against further substantial easing of money market conditions, and indeed there are substantial risks in the already wide adverse spread between domestic and foreign interest rates.

Faced with these difficulties, we can find some satisfaction in the course of the money and credit aggregates for the year to date and as projected for the fourth quarter. The magnitudes seem about right, but we have obviously been rather lucky. As Governor Daane has suggested several times, the System runs the risk of falling into the trap of overemphasizing small variations in the aggregates. I would hope we could find a way to downgrade them somewhat in the public mind. I am by no means convinced that there is as close a relationship between money supply growth and subsequent economic conditions as the monetarists would have us believe.

At the present time I think we should give increased emphasis to money market conditions, which have eased progressively and to a pronounced degree for many months. Just to take a single figure, Federal funds have moved from the 8 per cent level last summer to about 5 per cent at present. Indeed, I have been tempted by the idea of reverting to the older form of the directive, phrased in terms of money market conditions, with a proviso clause relating to the aggregates.

However, this may be going too far at this time, and I believe that alternative D, properly interpreted, would bring about approximately the same results. Alternative E, just proposed by Mr. Mitchell, also would be satisfactory to me.

We are in a period when a rebound from the auto strike is likely, for a time, to entail a more rapid growth of money and credit. If the fourth-quarter growth rates turn out, as now projected, to be about 5 per cent for money supply and about 8 per cent for bank credit, then a somewhat faster growth in the aggregates--perhaps about 6 and 10 per cent, respectively--might be appropriate for the first quarter. But I do not think we should overemphasize the importance of hitting such targets on the nose. It seems to me that the size of the recent data revision has dramatized the meaninglessness of any such effort at fine tuning. If we appear over the next month to be on a track that is consistent with a money supply growth rate in a range of, say, 5 to 7 per cent, and a bank credit growth rate of 8 to 12 per cent, I would be content.

It seems perfectly reasonable, as is suggested in the blue book discussion of alternative D, to expect that maintenance of recent money market conditions, exemplified by a Federal funds rate in the 5 to 5-1/4 per cent range, is consistent with the above set of goals. However, if the aggregates deviate outside of the ranges I have suggested, I would be prepared to let the funds rate edge down to 4-1/2 per cent, or up to 5-3/4 per cent.

There are two respects in which I would like to change the wording of D. First, I would drop the words "to promote some easing of conditions in credit markets," since this does not seem to be a primary objective in the general context of "no change." Second, I would eliminate the word "attendant" before "bank credit" to allow somewhat greater emphasis on this measure. As I have said, however, I believe alternative E would serve equally well.

With respect to the discount rate, I would have real qualms about a further cut in the near future. Fortunately, market rates have not declined much since the last move, so that a change is not called for on technical grounds, and to the extent that it would be regarded, at least in some degree, as a signal of progressive easing it is very much to be avoided. I regretted that the last two rate reductions came in such rapid succession, tending to create an impression of great zeal on the part of the System to ease credit; and I might add that our directors accepted only with the greatest reluctance my recommendation of the 1/4 point decrease of two weeks ago.

Mr. Morris said he would accept alternative C on the grounds that the Committee's recent policy clearly had not been sufficiently expansionary, and that a more expansionary policy was in order at least for the short run. He had no strong conviction as yet as to whether it would be appropriate to maintain growth in money at a 7 per cent annual rate for an extended period, but he thought growth at that rate should be sought at this point. For that purpose it was likely to be necessary for the Federal funds rate to decline below 5 per cent in January.

In that connection, Mr. Morris continued, a good deal of stress had been laid on the implications for financial market developments of the return to work at General Motors. However, the Committee seemed to be overlooking the fact that seasonal forces normally exerted downward pressures on short-term rates in January. If the Manager were given targets in terms of money market conditions--involving, say, a Federal funds rate in a 5 to 5-1/4 per cent range--he might well find it necessary to operate against tendencies for rates to decline seasonally, with undesirable consequences for money supply growth. Accordingly, he (Mr. Morris) thought it would be appropriate to focus primarily on the money supply in the directive.

Mr. Coldwell remarked that he had been reasonably pleased with the outcome of the Desk's efforts since the last meeting to probe toward a somewhat easier monetary posture. At present, however, he would favor holding money market conditions at roughly their present levels--with the Federal funds rate at about 5 per cent and the Treasury bill rate in a range of 4-3/4 to 5 per cent--and accepting whatever growth rates resulted for the aggregates. In his judgment the money growth rates projected in the blue book for December and January on the assumption of unchanged money market conditions--on the order of 8 or 9 per cent--would make up for the shortfalls that occurred in October and November and would prove adequate for the needs of the economy.

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For such reasons, Mr. Coldwell said, he was attracted to alternative E for the directive. Alternative D would also be acceptable if the reference to promoting some easing of credit market conditions was deleted. He would not want to validate any downward pressures on short-term rates that were not expected to be sustained over a longer period. He expected long-term rates to move down a bit and would not resist such declines, but he would be reluctant to lead market interest rates down.

In reply to a question by the Chairman, Mr. Coldwell said he would favor some easing of prevailing money market conditions if the staff projections proved wrong and the aggregates were found to be growing hardly at all under those conditions.

Mr. Swan remarked that he was in substantial agreement with the comments just made by Mr. Coldwell. He thought it would be appropriate at present for the Committee to focus primarily on the period until the next meeting, given the large expansion in activity expected--even though the magnitude of that expansion reflected the ending of the auto strike--and the various cross-currents at work. He would not want to have anything done to hinder the increases in the monetary aggregates expected in the short run. He saw no need for the members to commit themselves at this time to any particular policy course for the longer run.

Mr. Swan observed that he could accept alternative D for the directive but he preferred alternative E. He would define

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"present money market conditions" as including a Federal funds rate around 5 per cent. However, because he expected growth in the monetary aggregates to accelerate from recent rates, he would suggest amending the second sentence of alternative E by adding the words "at least" before "the recent." The sentence would then begin "It is expected that at least the recent rates of growth in money and bank credit will be maintained...."

Mr. Galusha said he preferred alternative C* for the directive. As he understood Mr. Maisel, the objective under that alternative was to allow for the possibility that there would be aberrations in the movements of market rates which the Committee would want to accommodate while holding to the goal of achieving more rapid monetary expansion over the quarter. He assumed that under such a directive the Desk would have sufficient latitude to keep the market from falling out of bed.

Mr. Mayo commented that the notion of consistency in monetary policy was attractive to him. The money supply had grown at an annual rate of about 6 per cent in each of the first three quarters of 1970 but apparently was growing at a rate of about 5 per cent in the current quarter. In light of that history he saw no objection to a 7 per cent growth rate as the target for the first quarter of 1971; such a rate would simply

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return the money supply to its earlier path. Any extended discussion of possible target rates for the individual months within the quarter struck him as dancing on the head of a pin--granting, of course, that the Manager had to keep the expected intra-quarter path of money growth in mind in making his operating decisions.

Mr. Mayo said he also favored C* for the directive. In his view that alternative not only represented the best course for policy at present but also would give the Manager the necessary degree of flexibility. He added that in favoring adoption of a first-quarter target of growth in money at a 7 per cent rate he was not suggesting that a commitment be made to maintaining that target rate indefinitely; the Committee would, of course, remain free to modify the target at any future meeting. For the present, he thought aiming for a 7 per cent money growth rate would not require moving the Federal funds or Treasury bill rates to levels so low as to cause additional problems with respect to the balance of payments or in restimulating inflation.

Mr. Clay said there could be no doubt that the economy was going to continue to be plagued by the twin problems of a sluggish performance in activity and persistent price inflation. A marked turnaround in the economy during the first quarter of next year was generally expected as a result of the termination of the auto strike, but the over-all pace of growth could hardly be expected to continue thereafter. Yet there remained the

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possibility that the very important consumer sector would perform better than now expected, along with probable improvement in residential construction and added State and local government spending.

However, Mr. Clay continued, a sluggish economy with unemployment probably increasing as the labor force grew did not give the green light to a highly stimulative monetary policy. The reason was the obvious fact that the price inflation problem continued acute. And that view was not denied because the price inflation was predominantly of the cost-push variety at this stage and therefore difficult for monetary policy to restrain. An overly expansive monetary policy certainly could aggravate the price inflation problem. So the Committee had to continue to walk the narrow path in terms of monetary policy's impact on economic activity and employment of resources and the restraint of price inflation; and there was room for difference of judgment as to where that narrow path lay.

Mr. Clay commented that it was repetitious but important to say that some Governmental action was needed on the wage-price front. The current inflationary episode had proceeded so far and had become so involved in the wage-cost structure that there was serious doubt that the inflation could be curbed by any feasible monetary-fiscal policy mix without such assistance. Moreover, it had been and continued to be necessary for public economic policy to provide some stimulus to the economy.

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Monetary policy had already come a considerable distance on the expansive side, Mr. Clay continued. And in recent weeks the adjustment in the money and capital markets had been both large and rapid. Moreover, both bank credit and the money stock had increased faster than earlier anticipated. In looking at the projections, it became apparent that even under alternative A of the draft economic policy directives the prospective growth rates for bank credit and money were large for both December and January.

In concluding, Mr. Clay observed that there would be opportunity at the next meeting to review the state of the economy, along with the developments in the monetary aggregates and the money and capital markets. Perhaps more also would be known about the probable course of fiscal policy and any possible Governmental action on the wage-cost front. Until that time, it would appear best to go along with policy alternative E, or alternative D as modified and explained by Mr. Hayes.

Mr. Heflin said his conclusions on policy were similar to those of Messrs. Coldwell and Swan. He would not like to see any backup in interest rates from their present levels; in general, he thought that present interest rates and rates of growth in the aggregates were both about in line with the targets the Committee had set, and that the Committee's longer-run objectives were essentially the same as at the time it had set those targets.

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As to a directive for the coming period, he would consider satisfactory either alternative E or alternative D with the modifications proposed by Mr. Hayes.

More generally, Mr. Heflin continued, he was concerned about two things. First, he thought that when the Committee began establishing and publishing specific targets for the money supply it had launched on a course that involved some serious risks, in that it encouraged outside observers to focus exclusively on the money supply in evaluating policy. The Chairman's recent speech in California had done a great deal to ease that problem; and he hoped that the Chairman, as spokesman for the System, would take every opportunity to emphasize that the money supply was only one of a variety of targets with which the Committee was concerned. Secondly, he was disturbed by the tendency to adopt the newspaper practice of talking about economic prospects in terms of mid-1972. That particular date was significant only for political reasons, and he hoped that System people would avoid giving it greater stress than any other date.

Chairman Burns said he wanted to underline that comment.

Mr. Mitchell said he had submitted alternative E for consideration chiefly because he thought a little more time would be needed before the effects on the aggregates of recent changes in policy became apparent. Given the nature of System operating procedures, patience was required in waiting for the aggregates to respond.

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In the meantime, Mr. Mitchell continued, there had been some appropriate developments. Long-term interest rates had begun to move down; although they still had some distance to go to reach appropriate levels, he thought they would be brought down in time by the pressure of flows of funds to financial institutions. Savings flows to banks and other intermediaries had been quite strong, and although banks had been slow to react they apparently were now beginning to move toward more aggressive solicitation of loans.

Since existing conditions in credit markets might be those required to achieve the Committee's aggregative objectives, Mr. Mitchell said, he would favor holding to such conditions for the time being and postponing consideration of policy for the longer run until the next meeting. Such a course appeared desirable also because of the difficulties of assessing the future now, in light of the expected churning in financial markets around year end and into January. With respect to the specific language of alternative E, the "present money market conditions" he had in mind included a Federal funds rate centering on 5 per cent. By "recent rates of growth in money and bank credit" he intended the average of the growth rates currently estimated for November and projected for December; for the money supply, the two growth rates in question were 4.5 and 9 per cent.

In conclusion, Mr. Mitchell noted that while alternative E was his first choice for the directive, his second choice was alternative C* and his third was D.

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Mr. Daane commented that the important issue facing the Committee today was the general posture of monetary policy, as it was reflected in the directive for the guidance of the Manager and the information of the public. Obviously, that posture should be one that would continue to contribute to the restoration of sustainable economic growth. It should be recognized that monetary policy could not do the job alone--that an appropriate mix of monetary and fiscal policy was needed. In that connection he was disturbed by the absence of any reference to fiscal policy in the draft of the first paragraph of the directive; and by the fact that with a few exceptions, including the comments by Mr. Galusha, insufficient attention had been paid to the subject in the discussion this morning. He might note that he sympathized with Mr. Galusha's observations on fiscal policy.

Mr. Daane remarked that the second paragraph of the directive issued at the preceding meeting--which was included among the alternatives for today as alternative D--conveyed the sense of acting against the recessionary tendencies in the economy by gradually easing monetary policy. Since he thought that remained the proper general stance of policy he would be disinclined to change the directive. In short, he favored alternative D; and he would not want to delete the statement about promoting "some easing of conditions in credit markets" as Mr. Hayes had suggested.

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Mr. Daane said he thought the Committee had put itself in a trap by setting precise targets for the money supply and he would not favor doing so now. At the same time, he noted that despite the easing of money market conditions in recent months it had not been possible to avoid shortfalls in money supply growth. At present he would be quite prepared to accept deviations in an upward direction in the process of continuing to ease.

Mr. Daane added that it would be desirable to keep developments in international payments under close review in the coming period. He suspected that further action by the Board would be needed in the Euro-dollar area, especially if the money supply were growing at an 8 or 9 per cent rate.

Mr. Maisel remarked that he agreed with much that had been said by Messrs. Mitchell and Daane as well as by some other members, but he disagreed about the appropriate language for the directive. In particular, he thought the directive should make clear that the Committee had changed the direction of its policy and did not intend to back away from that change. Clarity in today's directive was especially important since, under the usual practice of releasing all of the directives through the end of the year in advance of the Chairman's testimony before the Joint Economic Committee, it would be published in about 60 rather than the usual 90 days. As the members would note, in alternative C* he had proposed language calling for "somewhat more rapid growth" in money in place of the

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words "moderate growth" used in the present directive and alternative D. In his judgment such a substitution was needed not only for the guidance of the Manager but also to make clear to the public that the Committee had changed policy.

With respect to specifics, Mr. Maisel continued, he thought the Committee had been following an appropriate course in focusing on growth rates in the aggregates over quarterly periods rather than emphasizing movements in individual months. The Committee's proper concern now was with the entire first quarter. The action taken today could not be expected to have much effect on the January flows, which were highly uncertain in any case. The important thing was to make sure that policy was moving forward rather than backward. According to the blue book, to accomplish much forward movement it would be necessary to have a Federal funds rate centered on 4-1/2 per cent--not 5-1/4 per cent, which represented one interpretation of existing money market conditions. Apparently most members would agree that the funds rate should be at least as low as 5 per cent. In his judgment it should be somewhat below 4-3/4 per cent.

As he had indicated at the previous meeting, Mr. Maisel remarked, he thought the Committee should not accept the low GNP growth rates projected by the staff as appropriate goals of policy. It should set its sights higher than those conditional forecasts, and adopt a policy that at least would be consistent with growth

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in output as large as the growth in production potential. If output expanded with the growth in the labor force, the unemployment rate for the year 1971 would not increase above the current quarter's estimate of 5.7 per cent.

In terms of the staff forecast, Mr. Maisel observed, real output would have to rise by approximately 2 per cent more than shown in the projection. He did not know what level of growth in the monetary aggregates that would require. However, since the objective would be an increase in real GNP at least 4 per cent faster than this year, at a minimum money and credit would be expected to increase at an annual rate 2 or 3 per cent faster than in 1970.

As he had also indicated at the previous meeting, Mr. Maisel said, for the present he believed the Committee should think of growth rates in the aggregates not as targets but as a constraint setting upper limits to the actual growth rates. Given the desired growth of output, such a constraint should be set considerably above the path associated with alternative C. The Committee need not be concerned with the aggregates unless they went through the constraint. It should set its policy in terms of desirable short-term market conditions and interest rates, and concern itself with the flows only if they went well above the levels shown in connection with alternative C as adjusted for possible short-term flows resulting from the

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unwinding of the auto strike. In the coming month he would favor conducting operations with a view to keeping the Federal funds and Treasury bill rates near the lower end of the ranges specified in the blue book in connection with alternative C. With respect to directive language, he favored alternative C*.

Mr. Brimmer commented that the staff's analysis suggested the type of economic environment that it would be necessary to live with for a good part of 1971. In his judgment the policy course which Mr. Partee thought would be required to produce declines in the unemployment rate after the fourth quarter of 1971 would involve a degree of economic stimulation that would more or less guarantee the sacrifice of the objective of controlling inflation. He thought the Committee should not follow such a course; nor should it attempt to achieve economic growth rates anywhere near those being mentioned in the press. In his view the Committee should hold to the course it had been following-- that of providing some stimulation but not enough to be counter-productive.

Mr. Brimmer agreed with Mr. Heflin that the Committee should not be focusing on the situation in mid-1972 at this time, especially since the green book projections did not extend that far into the future. Indeed, he thought it would be best today to concentrate on the period until the next meeting and not try to set targets for the first quarter. The year end was a time at

which general economic reviews were being made in many quarters, and by the next meeting the Committee would have a clearer idea of the new Federal budget, the analysis of the Council of Economic Advisers, and so forth.

In no event, Mr. Brimmer continued, would he want to adopt a directive today that called for more rapid growth in money. He agreed that the Committee had changed its policy, as reflected in successive directives calling for promotion of easier conditions in credit markets. But those actions had been associated with the objective of achieving moderate growth in the monetary aggregates. It now looked as if a growth rate in money of about 5 per cent would be achieved for the fourth quarter. While he had never placed much weight on achieving that particular growth rate, it had been specified by the Committee as the longer-run target. At present he would have no objection to a modest pickup in the growth rate--perhaps to 6 per cent--but he would not want to stress such an objective. In fact, he thought alternative D, with the changes suggested by Mr. Hayes, would be appropriate for the directive.

Mr. Brimmer added that he could also accept alternative E. He was troubled, however, by the language calling for maintenance of present money market conditions "over the year end," since the directive would remain in force until the Committee's next meeting on January 12.

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Mr. Mitchell remarked that the phrase Mr. Brimmer had questioned might be replaced by the phrase "until the next meeting of the Committee."

Mr. Sherrill commented that recent economic developments were bearing out the earlier expectations of sluggishness in the economy. They also supported the view that the weakness would continue in 1971, except for a temporary resurgence in the first quarter reflecting the catch-up from the auto strike. Special care was needed in formulating policy now because of the risk that hopes of a sustained recovery would be stimulated by that resurgence, only to be dashed at the end of the quarter. In his judgment such a sequence of developments would be highly dangerous.

If a sustained recovery was to take place soon, Mr. Sherrill continued, he thought it would have to begin in the first quarter; if the recovery did not begin then it would prove very difficult to get it started later in the year. For that reason it was important to avoid any suggestion of renewed restrictiveness in monetary policy. Prevailing money market conditions should at least be maintained, if not loosened slightly. In general, he would suggest that the objective during the period of turbulence immediately ahead be that of insuring that any signals given regarding policy be of a loosening rather than tightening nature. He considered sound the proposal to shift the emphasis from the aggregates to money market conditions during the coming period,

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as called for by alternative E of the draft directives. He would, however, want to modify alternative E as Mr. Swan had suggested, to indicate the expectation that "at least" recent growth rates of the aggregates would be maintained. And he concurred in the proposal that "present money market conditions" be taken to include a Federal funds rate centering on 5 per cent.

Mr. Sherrill went on to say that it was highly unlikely that any mix of monetary and fiscal policies, taken by themselves, could reduce the unemployment rate significantly from the levels projected in the green book without having counter-productive consequences. It would be necessary, in his judgment, to supplement moderately stimulative monetary and fiscal policies with an incomes policy. He hoped System officials would stress the need for an incomes policy at every opportunity.

Mr. MacDonald noted that the projections for 1971 prepared by the staffs both at the Board and at the Cleveland Reserve Bank indicated continued slow economic growth, rising unemployment, and persistent inflationary pressures. The apparent decline in real GNP this quarter would further widen the gap between potential and actual GNP. Furthermore, projected rates of real growth over the next several quarters would not be sufficient to narrow the gap or improve the employment situation. The Cleveland Bank staff expected no significant moderation in upward price pressures next year despite persistent underutilization of resources. Increased

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productivity gains--which were, of course, a key to easing cost-price pressures--might be largely absorbed in restoring depressed profit margins and thus contribute only marginally to further price relief.

Developments in financial markets since the last meeting of the Committee had led to reduced market pressures, Mr. MacDonald observed. In spite of large demands for funds, both short- and long-term yields had fallen sharply. There were some indications that, as a result of improved liquidity positions, commercial banks were moving into intermediate- and longer-term municipal issues. Also, banks had continued to reduce their use of nondeposit sources of funds. Savings flows into all types of deposit institutions had shown significant increases, and mortgage lending activity seemed to be picking up.

It was his view, Mr. MacDonald said, that a target rate of about 6 per cent average growth in the money supply over the first quarter of 1971 was appropriate at the present time. According to estimates of the Cleveland Bank staff, maintaining rates of growth in the money supply on the order of 7 per cent and above would not lead to a substantial improvement in the unemployment situation in 1971 and would probably lead to additional inflationary pressures in late 1971 and 1972. In view of the uncertainties in the economic and financial situation, he would prefer alternative E of the draft directives.

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Mr. Eastburn said he agreed with those who believed there were dangers in the Committee's trying to do things it could not do. For that reason he thought it would be desirable to return to more familiar territory. He would like to believe that inflationary expectations were subsiding, but he was far from convinced that that was the case. Therefore, he thought the Committee should avoid giving any impression that it was moving toward greater ease.

In his judgment, Mr. Eastburn continued, 5 per cent would be an adequate rate of growth for money in the first quarter. However, in view of the many uncertainties with respect to the short run he agreed that it would be wise to adopt alternative E for the directive today. Under that alternative he would favor easing money market conditions if it appeared that money growth was running below the 5 per cent path.

Mr. Kimbrel observed that, because of the difficulties that had been noted of assessing likely developments over the year-end, he would favor adopting alternative E today if he had a choice. That, however, represented his preference only for the short period until the January meeting. For the long run, he hoped the Committee would not lose sight of the need to hold to a steady course in order to restore confidence that it continued to be concerned about inflation. At the moment, however, it would be desirable to give the Manager considerable latitude to deal with a difficult situation.

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Mr. Francis commented that two general monetary policy alternatives were now under active consideration. First, the 5 per cent rate of monetary expansion, which had been the goal of policy since June and had been achieved, could be maintained. Second, a more rapid rate of monetary growth could be adopted to accelerate growth in real output.

Mr. Francis said the first alternative--maintenance of the present 5 per cent rate of money growth--would probably assure steady progress toward moderation of price increases. Real output would grow at a gradually increasing rate, but considerable time would be required for achieving a high level of employment. The second alternative--accelerated monetary growth--might, according to the Board's model and that of the St. Louis Bank, lead to greater growth in real output next year with only somewhat slower progress against inflation than under present policy. However, in his view the situation after 1971 would be less favorable. A very rapid growth of total spending to foster an acceleration in real output growth for the next few quarters would probably prolong inflation and could very well result in intensified inflation later on.

Mr. Francis noted that various commentators had contended that under either alternative the time required to curb inflation was too long and the economic slack required too great. Concern had also been expressed that inflation might be intensified by

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rapid monetary expansion. Various forms of income policies had been advanced to meet those objections.

Mr. Francis believed that most versions of an incomes policy would not eliminate those objections unless powerful administrative controls were included. Experience with such devices as wage-price guidelines, which were abandoned as futile in the mid-1960's, suggested that in the present inflationary situation a weak incomes policy should not be expected to contribute very much. Although demand-pull inflation had been substantially reduced, there still were many who were attempting to catch up with the inflation to date and to hedge against assumed future inflation. The adoption of administrative controls in attempting to hold down inflation, or to shorten the period of adjustment, would impose a great cost on the private enterprise economy. Serious inefficiencies would develop in the operations of the market system. A more promising approach to shortening the time frame and reducing the costs of a restrictive policy was the one recently advanced by the Chairman for improving the functioning of the market system.

With regard to current monetary policy, Mr. Francis preferred a continuation of the 5 per cent rate of monetary expansion which had prevailed since June. He was somewhat at a loss to understand the suggestion that shortfalls be made up; since money had been growing at a 5 per cent annual rate, there seemed to him to be nothing to make up. He was also disturbed by the

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suggestion today that the Committee abandon aggregative targets, even for a short period, and return to money market conditions as the primary target. Of the various proposals for the directive offered today, alternative A of the staff's drafts would best meet his specifications.

In concluding, Mr. Francis said he endorsed the recent suggestions of the Chairman for assisting monetary policy to produce both price stability and full employment. The Chairman's proposals would allow stabilization policy to be effective without threatening the viability of a free economy.

Mr. Robertson made the following statement:

As I see it, there have been no major surprises in economic developments since the last meeting of this Committee. Total spending remains quite sluggish. Christmas sales are reported to have been disappointingly weak thus far, but I would not rule out the possibility of an upturn now that the uncertainties associated with the auto strike are largely past. On the wage and price front, I still have not seen enough evidence that a sustainable cooling-off process is under way, and recent wage settlements would seem to assure continued pressures in that area.

Interest rates, on the other hand, have moved down substantially, although not so sharply as to cause me concern. In fact, the rate drop is a welcome development to the extent that it represents a breaking of the log-jam of market attitudes and thus may be connected with some modification of inflationary expectations. Furthermore, the decline in itself reduces what has been a painfully high cost element in current credit transactions--an effect too often overlooked.

In this environment, the appropriate course for monetary policy remains, I believe, one that will promote eased conditions in credit markets and moderate and orderly expansion in money and bank credit.

But this is not a course that will be easy to pursue between now and the next meeting of the Committee. Given the year-end churning in prospect and the general uncertainties afflicting our current estimates of the aggregates, I think the wisest operational instruction to the Desk would be to maintain money market conditions essentially unchanged over this interval. I would not want to see interest rates back up significantly right now. The false impressions generated by any such move could undo a good part of what we have recently achieved in altering attitudes. I would hope that with such a policy, the money supply growth would be at about a 5 per cent annual rate, but if it moderately exceeded that growth rate temporarily, I would not be concerned.

I would like to take this opportunity to suggest that as we move along we guard against placing excessive reliance on movements in money narrowly defined as the single target measure of aggregate monetary performance. I say this not only because M_1 is peculiarly afflicted with revision problems. These can be troublesome, as we all know, but more basically I am concerned about the important facets of monetary activity this measure excludes. In the kind of economy we presently have, a good part of the additional funds provided to consumers by an expansive policy is squirreled away in savings accounts as opposed to non-interest-bearing demand accounts. I am not saying this is a bad tendency, but to ignore it as we try to judge the results our policies are creating would be unrealistic and perhaps misleading. I would therefore suggest that we give more attention to the performance of M_2 -- (i.e., M_1 plus consumer time and savings deposits)-- and perhaps also some attention to the flows of consumer funds into non-bank thrift institutions (i.e., M_3).

Also, I would like to note that for at least fifteen months I have felt the need for national leadership in the form of an appeal to both management and labor to exercise voluntary restraint in further wage and price increases, in order to curb inflation and make the transition to noninflationary prosperity quicker, smoother, and more certain. I mention this only to lay a base upon which to express my gratification that at long last the President has taken some steps in this direction. Last week Chairman Burns made a constructive contribution to the same end in pointing out additional steps that could be taken. I fervently hope that these efforts, followed up in an appropriate and timely fashion,

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will bear fruit and help us avoid distasteful mandatory controls over wages and prices.

Finally, in terms of instructions to the Manager, my policy ideas can be accommodated best by adopting alternative E of the language suggestions for the second paragraph that are before us. I would interpret that alternative as being designed to prevent present money market conditions from tightening over the year-end.

Chairman Burns said he thought it was necessary to recognize that the economy was in a recession which was being aggravated by a deterioration of confidence and which might become international in scope. Monetary policy alone could not deal with the present situation, in which inflation continued simultaneously with recession and confidence was weak and becoming weaker. Nevertheless, the System had to do what it could to help stimulate the economy and to make a constructive contribution, however modest, to the solution of the diverse economic problems facing the nation.

The Chairman noted that a good deal had been said this morning about the undesirability of focusing narrowly on a specific target for the money supply. He thought it was necessary to recognize that each release of money supply statistics was now scrutinized with the same anxiety as was accorded figures on the cost of living and unemployment. While one might deplore that situation, it was a fact of life that had to be taken into account. One consequence was that shortfalls in the money supply such as had occurred in October and November, if repeated, could become extremely troublesome under current circumstances. In his judgment such shortfalls should be avoided.

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At the same time, Chairman Burns continued, something should be done to educate the public--including politicians and economists--as to the meaning of the money supply figures. He hoped all of the members would give serious thought to possible means for doing so. He was thinking of making a speech on the subject of "monetarism." Also, it would be helpful if the term "money" was not identified so closely with a single series--private demand deposits plus currency, the so-called "M₁." Actually, there were a number of different useful definitions of money, and the Board was planning to revise its statistical releases to provide information in them for money on various definitions.

With respect to the directive to be issued today, the Chairman noted that there seemed to be substantial sentiment in the Committee for both alternative D and some form of alternative E. He believed that a particular variant of alternative E would come close to expressing the Committee's consensus. The language he had in mind was as follows:

To implement this policy, System open market operations shall be conducted with a view to maintaining the recently attained money market conditions until the next meeting of the Committee, provided that the recent rates of growth in money and bank credit will at least be maintained.

He would suggest that "recently attained money market conditions" be interpreted as including a Federal funds rate of about 5 per cent, and "recent rates of growth in money and bank credit" as

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involving growth rates of 6 and 12 per cent, respectively. Also, he thought the statement regarding maintenance of at least those growth rates should be taken to apply to the first quarter as a whole, rather than to January or to the period until the next meeting.

Mr. Daane commented that it was important not to seem to rule out growth rates in the first quarter in excess of the 6 per cent target. With that thought in mind, he would suggest replacing the final word, "maintained," with "achieved."

In reply to a question, Mr. Holland said the growth rates the Chairman had mentioned were roughly the average of the rates now shown for November and December. In effect, those averages would be taken as indicating the minimum growth rates desired for the first quarter.

After further discussion, Chairman Burns said it would be helpful if the Manager would describe his understanding of the directive language under consideration.

Mr. Holmes said he would interpret the language in question to call for holding the Federal funds rate at a level around 5 per cent at the outset of the coming period. He understood it was the Committee's hope that the funds rate could be kept at about that level during the period, but that money market conditions should be eased if incoming data indicated that the money supply was likely to grow at a rate of less than 6 per cent during the first

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quarter. However, he was not sure about the precise "trigger point" for deciding that money growth was inadequate. He also was not sure whether the Committee intended to set any upper limit for money growth.

Mr. Daane suggested that money growth should be considered inadequate if it fell below a path consistent with a 6 per cent growth rate in the first quarter. Messrs. Sherrill and Mitchell concurred.

Mr. Maisel added that the path associated in the blue book with a first-quarter growth rate of 6 per cent specified monthly growth rates of 9.5 and 8 per cent, respectively, for December and January. He thought money market conditions should be eased if money growth in those months appeared to be falling more than a point or two below the indicated rates.

Mr. Hayes said he was a little disturbed by the emphasis on targets for individual months. In his judgment there was merit in the longer-run approach implied by quarterly targets, particularly in light of the uncertainties attaching to monthly projections. He questioned whether there was any need for concern over a momentary shortfall from a target path.

Chairman Burns remarked that, as he had indicated earlier, he would be inclined to place greater weight on history than on projections. Therefore, he would attach considerable importance to the performance of the monetary aggregates as the figures came in week by week.

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The Chairman then asked whether there were any other comments before a vote was taken on the directive.

Mr. Partee said there might be a technical objection to the phrase "recent rates of growth" if the term "recent" was intended to apply to December as well as November. At the moment, reasonably firm information on the monetary aggregates was available only through the week of December 2; the figures shown for December were almost wholly projections.

After discussion it was agreed that it would be appropriate to refer to "expected" rather than "recent" rates of growth.

The Chairman then suggested that the Committee vote on a directive with a first paragraph consisting of the staff's draft and a second paragraph consisting of the language he had read, with changes to take account of the comments of Mr. Daane and Mr. Partee.

Mr. Francis said he would find it necessary to dissent from such a directive.

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

The information reviewed at this meeting suggests that real output of goods and services has declined since the third quarter, largely as a consequence of the recent strike in the automobile industry, and that

unemployment has increased. Resumption of higher automobile production is expected to result in a bulge in activity in early 1971. Wage rates generally are continuing to rise at a rapid pace, but gains in productivity appear to be slowing the increase in unit labor costs. Movements in major price measures have been diverse; most recently, wholesale prices have shown little change while consumer prices have advanced substantially. Market interest rates declined considerably further in the past few weeks, and Federal Reserve discount rates were reduced by an additional one-quarter of a percentage point. Demands for funds in capital markets have continued heavy, but business loan demands at banks have been weak. Growth in the money supply was somewhat more rapid on average in November than in October, although it remained below the rate prevailing in the first three quarters of the year. Banks acquired a substantial volume of securities in November, and bank credit increased moderately after changing little in October. The foreign trade balance in September and October was smaller than in any other 2-month period this year. The over-all balance of payments deficit on the liquidity basis remained in October and November at about its third-quarter rate. The deficit on the official settlements basis was very large as banks continued to repay Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations shall be conducted with a view to maintaining the recently attained money market conditions until the next meeting of the Committee, provided that the expected rates of growth in money and bank credit will at least be achieved.

Chairman Burns then observed that Mr. Bodner had indicated earlier in the meeting that he had certain recommendations to make concerning the System's swap arrangements. He asked Mr. Bodner to present those recommendations at this point.

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Mr. Bodner noted that at its November meeting the Committee had approved the renewal for another year of all of the System's swap arrangements that matured on December 2. There remained the arrangements with the central banks of Canada and the Common Market countries, which matured on various dates from December 16 through December 30. Mr. Coombs had not included the latter among those for which he had recommended renewal in November because of expectations that the Belgians and the Dutch would want to discuss certain problems regarding the operation of the arrangements--partly on their own behalf and partly on the behalf of some other Common Market central banks.

As indicated in his recent memorandum ^{1/} to the Committee, Mr. Bodner continued, fairly extensive discussions of the matter had now been held with representatives of the Belgian and Dutch central banks; and Mr. Coombs had had further discussions last weekend in Basle with representatives of certain Common Market banks. The Common Market banks involved were prepared to renew the swap lines at this time, on the understanding that discussions would take place over the next month or so looking toward a satisfactory resolution of the problems raised. He would recommend today that the Committee approve the renewal for another year of

^{1/} The memorandum referred to was dated December 8, 1970, and entitled "Proposed modification of procedures to be employed in transactions under certain swap lines." A copy has been placed in the Committee's files.

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the swap arrangements with the Bank of Canada and the Common Market central banks, with the understanding that the latter might include a condition along the lines he had mentioned in their acceptances. In addition to learning whether the Committee would be agreeable to that course, he would like guidance from the Committee with respect to the negotiations under way. In particular, he would like to know whether the members approved the approach that the New York Bank was taking in the negotiations, as set forth in his memorandum. He was prepared, if the Committee so desired, to comment on the problems and the means being discussed for their resolution.

Chairman Burns suggested that the Committee act with respect to renewal of the swap arrangements and then take up the problems to which Mr. Bodner had referred.

Mr. Mitchell asked what would happen if the arrangements were renewed on the basis of the proposed understanding but it was later found impossible to resolve the problems in question in a manner satisfactory to both the Federal Reserve and the other central banks.

Mr. Bodner said he would expect in that event that the affected swap lines would remain in force for the rest of the year, but only nominally; it would be understood that neither party would make drawings.

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By unanimous vote, renewal for further periods of one year of the following swap arrangements, having the indicated amounts and maturity dates, was approved:

<u>Foreign Bank</u>	<u>Amount of arrangement (millions of dollars)</u>	<u>Maturity of latest authorized renewal</u>
National Bank of Belgium	500	December 22, 1970
Bank of Canada	1,000	December 30, 1970
Bank of France	1,000	December 28, 1970
German Federal Bank	1,000	December 16, 1970
Bank of Italy	1,250	December 30, 1970
Netherlands Bank	300	December 30, 1970

Mr. Daane then observed that the questions that had been raised by the Belgians and Dutch involved highly complex technical considerations. In view of the lateness of the hour, he doubted that the Committee would be able to deal with those questions in an adequate manner today. Perhaps it would be better to delegate the matter to a subcommittee.

Chairman Burns endorsed Mr. Daane's suggestion. He noted that a subcommittee consisting of the Chairman and Vice Chairman of the Committee and the Vice Chairman of the Board, or certain specified alternates, was designated in paragraph 6 of the Committee's authorization for System foreign currency operations to act on behalf of the Committee in an emergency. He proposed that the same subcommittee be asked to act on the Committee's behalf with respect to the matter at hand, on the understanding that it would get in touch

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with the full Committee if it had any serious doubts about the appropriate course of action.

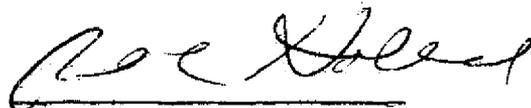
There was general agreement with the Chairman's proposal.

Mr. Bodner expressed the view that it would be desirable to dispose of the matter relatively soon. Accordingly, he hoped the subcommittee would be able to meet in the near future, before the next meeting of the Open Market Committee.

Mr. Brimmer observed that the central banks that had initiated discussions of the problem at hand--those of Belgium and the Netherlands--were among the smallest in the System's swap network. He would be concerned about any course of action that involved a wholesale revamping of the terms of the System's swap arrangements on the basis of objections to the present terms on the part of those two banks..

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, January 12, 1971.

Thereupon the meeting adjourned.


Secretary

ATTACHMENT A

Drafts of Current Economic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on December 15, 1970

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services has declined since the third quarter, largely as a consequence of the recent strike in the automobile industry, and that unemployment has increased. Resumption of higher automobile production is expected to result in a bulge in activity in early 1971. Wage rates generally are continuing to rise at a rapid pace, but gains in productivity appear to be slowing the increase in unit labor costs. Movements in major price measures have been diverse; most recently, wholesale prices have shown little change while consumer prices have advanced substantially. Market interest rates declined considerably further in the past few weeks, and Federal Reserve discount rates were reduced by an additional one-quarter of a percentage point. Demands for funds in capital markets have continued heavy, but business loan demands at banks have been weak. Growth in the money supply was somewhat more rapid on average in November than in October, although it remained below the rate prevailing in the first three quarters of the year. Banks acquired a substantial volume of securities in November, and bank credit increased moderately after changing little in October. The foreign trade balance in September and October was smaller than in any other 2-month period this year. The over-all balance of payments deficit on the liquidity basis remained in October and November at about its third-quarter rate. The deficit on the official settlements basis was very large as banks continued to repay Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee seeks to promote moderate growth in money and attendant bank credit expansion over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Alternative B

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and growth in money over the

months ahead at about the average rate prevailing in the first three quarters of 1970, with attendant bank credit expansion. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Alternative C

To implement this policy, the Committee seeks to promote easing of conditions in credit markets and somewhat more rapid growth in money over the months ahead than prevailed in the first three quarters of 1970, with attendant bank credit expansion. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Alternative D

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead, with allowance for temporary shifts in money and credit demands related to the auto strike. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.