

MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 9, 1971, at 9:15 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Heflin
Mr. Maisel
Mr. Mitchell
Mr. Robertson 1/
Mr. Sherrill
Mr. Swan
Mr. Mayo, Alternate

Messrs. 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, Garvy, Gramley,
Hersey, Hocter, Jones, Parthemos,
Reynolds, and Solomon, Associate
Economists

1/ Withdrew from the meeting at the point indicated.

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Mr. Holmes, Manager, System Open Market Account

Mr. Coombs, Special Manager, System Open Market Account

Messrs. Bernard and Leonard, Assistant Secretaries, Office of the Secretary, Board of Governors

Mr. Cardon, Assistant to the 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

Messrs. MacDonald and Strothman, First Vice Presidents, Federal Reserve Banks of Cleveland and Minneapolis, respectively

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

Messrs. Scheld and Green, Vice Presidents, Federal Reserve Banks of Chicago and Dallas, respectively

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

Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York

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Chairman Burns noted that the System had suffered its second great loss in a short period with the death on January 31, 1971, of Hugh D. Galusha, Jr., President of the Federal Reserve Bank of Minneapolis. At the Chairman's suggestion the participants in the meeting stood for a moment in silence in memory of Mr. Galusha.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on January 12, 1971, were approved.

By unanimous vote, the Committee ratified the affirmative action the members had taken on the recommendation, transmitted by wire of January 22, 1971, to suspend a provision of paragraph 1(A) of the continuing authority directive (the provision limiting exchanges with the Treasury of securities held in System Account to maturing issues) to the extent of enabling the Account Management to prerefund \$4 billion of System Account holdings of the 7-3/4 per cent note of November 1971 in the current Treasury financing.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period January 12 through February 3, 1971, and a supplemental report covering the period February 4 through 8, 1971. Copies of these reports have been placed in the files of the Committee.

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In supplementation of the written reports, Mr. Coombs said that the Committee might recall that at its meeting of November 17, 1970, he had referred to the letter of July 15, 1968 from former Secretary of the Treasury Fowler which assured the Committee of Treasury backstop facilities for Federal Reserve swap drawings. He had suggested that the Committee might inquire whether the present Treasury administration was in agreement with that letter. Messrs. Daane, Solomon, and he had subsequently visited Mr. Volcker, Under Secretary of the Treasury for Monetary Affairs, who had indicated that he was aware of the letter and had studied it closely. Mr. Coombs had gathered from that conversation that the present Treasury administration would stand by the commitment to settle outstanding swap debt by using the basic reserve resources of the United States. Mr. Volcker seemed to have the impression that in certain cases the Treasury might be able to make arrangements with the foreign central banks concerned that would enable the Treasury to raise the foreign currency needed through sale of dollars in the exchange markets. He (Mr. Coombs) was not as optimistic about the possibility of such arrangements. In general, however, he thought he could assure the Committee that the take-out facility provided by the Treasury's letter of July 15, 1968, was still in force.

Next, Mr. Coombs continued, the Committee would recall that at the meeting of December 15, 1970, Mr. Bodner had reported

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that the Common Market central banks had requested that all swap drawings and repayments be made at par so as to avoid reductions in normal operational profits or even outright losses by the central banks concerned. The Committee had referred the question to a subcommittee, consisting of the Chairman, the Vice Chairman, and Governor Robertson, and the subcommittee had approved a counter-proposal which was delivered to the Common Market central banks last weekend at Basle. He expected to get their reaction shortly, and would keep the Committee informed.

On the exchange markets, Mr. Coombs said, it had remained possible to finance the U.S. payments deficit without undue difficulty, although serious problems were building up for the future. In 1970, many of the dollars generated by the huge U.S. deficit had gone to countries which either needed the dollars or were prepared to hold them. As he had suggested at the Committee's previous meeting, that pattern might well prevail for much of the first quarter of 1971. Germany and Italy had continued to sweep dollars off the market while the Bank of England had been making major reserve gains and setting them aside to cover various debts still outstanding. The Rolls-Royce bankruptcy resulted in market losses of \$100 million by the Bank of England last Friday, but \$70 million was recovered yesterday and sterling was strong again today. It was his hope that sterling would remain strong for a number of weeks to come.

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Mr. Coombs reported that the main immediate problem was the continuing inflow of dollars into Belgium. Despite the Treasury's sale of \$110 million of special drawing rights and its drawing on the International Monetary Fund of \$125 million of Belgian francs, the System's swap debt in Belgian francs had risen to \$350 million. Belgian officials continued to predict an early reversal of their current account surplus but he saw no signs of that as yet.

Mr. Coombs noted that the System's earlier swap debt of \$300 million to the Netherlands Bank had been paid down to \$75 million, an amount that the Dutch officials hoped could be reversed by market transactions. That possibility now seemed unlikely and the Netherlands Bank had meanwhile increased its market swaps to \$200 million, much of which might come back into its holdings at maturity and therefore require new recourse to the Federal Reserve swap line.

In the case of the Swiss franc, Mr. Coombs said, the exchange rate continued to hold close to the ceiling. No possibility had yet appeared of paying off the System's \$300 million swap debt to the Swiss National Bank through market transactions, even though seasonal factors were strongly favorable, and the Swiss National Bank might soon ask that most of the \$300 million debt be settled through some combination of sales of gold and of bonds denominated in Swiss francs.

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The situation that was beginning to concern him even more, Mr. Coombs continued, was the rapid buildup in the dollar holdings of the Bank of France. The French now had between \$500 million and \$600 million of uncovered dollars apart from the dollars set aside against debt to the Fund, and at some--perhaps not too distant--point they might ask the System to take further dollar inflows off their hands.

On the matter of Euro-dollar flows, Mr. Coombs noted that in a recent memorandum discussing the proposal for System matched sale-purchase transactions^{1/} he had advised the Committee of his belief that the Bank for International Settlements might have been soliciting dollar deposits from the major European central banks for placement in the Euro-dollar market. At the BIS meeting last weekend he had verified that that was the case, but he thought that both the BIS and the central banks concerned now realized that the practice was not in the general interest, and that it should be eliminated. He had also verified that deposits with the BIS by the major European central banks now totaled more than \$2 billion. He believed that the central banks concerned would be prepared to shift as much as \$1 billion from the BIS

^{1/} This memorandum was dated January 18, 1971, and entitled "Euro-dollar outflow problem." A copy has been placed in the Committee's files.

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into U.S. Treasury bills if that course was recommended to them. Such a shift obviously would tend to raise Euro-dollar interest rates, thereby widening still further the spread from U.S. rates. Equally obviously, that effect on Euro-dollar rates could be fully offset by a further running down of about \$1 billion in U.S. bank debt to the Euro-dollar market. Such a runoff might be fostered by an appropriate modification of Regulation M, perhaps allowing banks to effect a temporary reduction in Euro-dollar liabilities without suffering a permanent cut in their reserve-free base.

More generally, Mr. Coombs said, at the Basle meeting he had found a severe hardening of attitudes with respect to the U.S. balance of payments situation, which apparently was precipitated by the publication of figures indicating the size of the 1970 deficit. It was reported at the meeting that the large outpouring of U.S. dollars in 1970, together with the creation of SDR's last year, had resulted in a 36 per cent increase in the reserves of the Group of Ten countries other than the United States. It appeared that rather strong resistance was developing to the SDR operation and strong impetus was being given to the European monetary union--not simply as a long-range plan but also as a contingency plan in the event of a breakdown in the international payments system. He was concerned about the probable

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impact, as those European attitudes became known to the press and the market, not only on the foreign exchanges but also on the gold market. The SDR scheme had seemed to rule out any possibility of an increase in the official price of gold. If the SDR scheme was now challenged the effects on the gold market could be highly disturbing.

By unanimous vote, the System open market transactions in foreign currencies during the period January 12 through February 8, 1971, were approved, ratified, and confirmed.

Mr. Coombs then reported that two System drawings on the National Bank of Belgium, totaling \$70 million, would mature for the first time on February 23 and March 9, respectively. It was possible that those drawings would be repaid if the Treasury were to make another drawing on the Fund or sell SDR's to the Belgians. However, he would recommend renewal of the two System drawings if necessary.

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

Chairman Burns noted that Mr. Daane also had attended the meeting at Basle during the past weekend and invited him to comment.

Mr. Daane said the atmosphere at the Sunday Governors' meetings was somewhat different from that Mr. Coombs had found at the Saturday

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technicians' sessions. Specifically, only a voice or two had been raised in challenge of the SDR scheme--most notably, by the Belgians--and the burden of Governor Ansiaux's point was that SDR's should never have been created in the first place.

In general, Mr. Daane continued, the Europeans had appeared to be preoccupied with their own problems, and with the plan of the Common Market countries for monetary integration. He might note that the Common Market Ministers were meeting in Brussels today, but the general expectation in Basle had been that they would not reach an agreement for another month or so. In the afternoon session there had been a brief follow-up to last month's discussion of the Euro-dollar market, on which Mr. Coombs had reported at the preceding meeting. It was agreed that a steering committee chaired by Mr. Zijlstra should meet later this month to plan further consideration of the Euro-dollar market. That had been followed by the usual quarterly multilateral surveillance discussion on a country-by-country basis, using whatever statistics were available for each country. However, the group passed over the United States, turning instead to consideration of a table showing 1970 reserve changes, to which Mr. Coombs had alluded. In addition to the 36 per cent increase Mr. Coombs had mentioned for the Group of Ten countries other than the United States, the table showed an increase in reserves for the world as

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a whole of 27 per cent excluding the United States and 17 per cent including this country. It was indicated that much of the reserve growth was in the foreign exchange component. At this point Mr. Ansiaux had expressed the view that the rise was too large no matter how it had come about. It was noted, however, that part of the increase--and possibly a significant part--could be explained by the double-counting of reserves resulting from the practice of central banks and international organizations of placing reserve funds in the Euro-dollar market. President Stopper of the Swiss National Bank had placed even greater stress on that fact than the U.S. representatives had. There was general agreement that the practice should be one of the first matters reviewed in further discussions of the Euro-dollar market.

In the evening session, Mr. Daane continued, Mr. Zijlstra had posed the questions of how the governors felt about current levels of interest rates generally and in their own countries. During the discussion careful consideration was given to U.S. interest rates. The general feeling was that too much reliance had been placed on monetary policy in the United States, with the result that interest rates here had been driven down to lower levels than were healthy for the world at large under prevailing economic conditions. He (Mr. Daane) had suggested that

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U.S. long-term rates perhaps were still too high, but that point of view had not been accepted by the group. They hoped that from this point on more reliance would be placed on fiscal policy and less on monetary policy. In particular, they hoped that the Federal Reserve would not act in a way that would place additional downward pressure on their domestic interest rates.

Chairman Burns asked whether there had been any appreciation of the fact that even in the absence of Federal Reserve action there would have been a considerable decline in U.S. interest rates because of the slump in economic activity.

Mr. Daane replied that he had made that point explicitly in the discussion. He had also called to the group's attention the recent lack of expansive strength in the U.S. money supply, and had noted that that development reflected the fact that the U.S. economic conditions had been weaker than expected.

Mr. Daane went on to say that the Europeans--especially the Germans--had welcomed recent U.S. actions to moderate the outflow of Euro-dollars from this country, and had raised the question of whether further actions of that kind could be taken. He should add that the governors' discussion of the practice of placing official reserves in the Euro-dollar market had focused on discontinuing such placements in the future rather than on

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reversing past placements. It was noted that reversals would put upward pressure on Euro-dollar rates and increase the incentive for U.S. banks to reduce their Euro-dollar liabilities.

Mr. Coombs agreed that there had been very little discussion of the possibility of reversing earlier placements. His point was that the European central banks might be willing to reverse a certain amount of those placements if asked, and that the impact on Euro-dollar rates could be offset by an equal runoff of Euro-dollar liabilities of U.S. banks. In other words, there were possibilities for joint action that would have the beneficial result of reducing the overhang of such liabilities.

The Chairman asked Mr. Solomon if he had any comments to make.

Mr. Solomon said he agreed that it would be beneficial to reduce the overhang of Euro-dollar liabilities, but there would be no benefit to the U.S. balance of payments if the shift of foreign central bank funds from the Euro-dollar market into U.S. Treasury securities was offset by an equivalent runoff of U.S. bank liabilities to the Euro-dollar market. The result would be that the United States would still incur a large deficit in 1971, with all of the implications that would have for the SDR program and the future stability of the dollar.

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The Chairman then called for the staff reports on 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 introductory statement:

The major economic news event since the last meeting of the Committee has been release of the Federal Budget for fiscal 1972 and of the President's Economic Message. Ordinarily, this has been the occasion for preparation of a new staff chart show evaluating prospects for the economy in the year ahead. Because of the lateness of the messages and the pressures of other activities, we do not have a chart show for you today. But we have thoroughly reviewed our continuing GNP projection as presented in the green book,^{1/} considered the implications for the balance of payments, the flow of funds, and interest rate movements of our GNP projection, and prepared alternative models of the economy based on somewhat different policy assumptions.

Our policy assumptions for the basic projection are that money growth would return to a 6 per cent annual rate, following a period of catch-up in the first quarter, and that actual Federal expenditures in fiscal 1972 would be about \$5 billion higher than indicated in the Budget, reflecting mainly passage of a larger social security increase this spring than assumed in that document. Despite this added stimulus, our expectations as to GNP growth over the year are only a little stronger than in previous economic reviews. As a result, our GNP projection for the year falls well below the \$1,065 billion total used in the Budget estimates and indicated in the Economic Report as being a desirable target for 1971. Feasible alternative policy assumptions would raise our projections somewhat, and would promise considerably greater growth in 1972, but still do not close the gap between Administration hopes and our expectations. The basic problem, as we see it, is that fundamental factors in the economy, including the continuation of

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

substantial inflation from the cost-push side, are too negative to permit any quick and substantial resurgence in over-all output relative to the economy's growing resource potential.

Mr. Wendel will lead off today with a review of the new Budget numbers and of their possible economic implications. Mr. Wernick will then review our projections for economic activity, resource use and cost-price developments, followed by Mr. Hersey with an analysis of balance of payments prospects. I will conclude with a discussion of the outlook for the flow of funds, interest rates, and the possible effects of alternative policy assumptions.

Mr. Wendel made the following statement regarding the fiscal 1972 Budget:

The new Budget calls for about a 7-1/2 per cent increase in Federal spending in fiscal year 1972, a growth rate that is about the same as that experienced during calendar year 1970. In our staff estimates, however, we have projected a somewhat higher growth rate in spending than that in the Budget, principally because we have assumed a larger social security benefit hike than the flat 6 per cent increase that is recommended by the Administration. A 10 per cent increase was passed last year by the Senate and is now also incorporated in Congressman Mills' new social security bill. Conforming to our GNP projection, we also have incorporated larger unemployment benefit payments and in addition we have added a minor amount for another postal pay increase in early 1972.

In other respects, the staff projection is consistent with the Budget plan. Thus, defense expenditures are projected to continue to decline over the next two quarters and, as a result, total Federal purchases in calendar year 1971 are expected to be 2 per cent less than in 1970. In calendar 1972, however, a sharp rise is scheduled in Federal direct purchases, since higher wages to encourage a volunteer Army are added to the regular January Federal pay raise. The increase in transfer payments, on the other hand, tapers off in calendar 1972 since the proposed cost of living adjustments in social security benefits are not scheduled until calendar 1973.

Looking at the current cyclical period as a whole, the projected rate of increase in Federal spending (in undeflated dollars)--from the late 1969 peak until the end of fiscal year 1972--is only slightly larger than the corresponding cyclical rise in the period of 1960 to 1962. In the current experience, however, the Federal spending increase is almost entirely concentrated in the area of transfer payments and grants to States, rather than being evenly distributed between direct purchases and supplements to incomes.

In a detailed breakdown of the Federal Budget by fiscal years--as projected by the staff--the changes in spending from fiscal 1971 to 1972 again show the heavy emphasis on transfer payments and grants-in-aid, with these two categories accounting for almost 85 per cent of the total projected rise in spending for fiscal 1972. If the Congress does not go along with the new \$4 billion revenue sharing plan, scheduled for introduction next October, other types of grant programs to the States would probably be increased instead. There is also some doubt about the shift to a volunteer Army next year, but the Congress might well put the funds requested for this purpose to use in other programs--defense or nondefense. Such shifts in allocation could still keep the total rise in Federal spending in the general area that we have projected.

The emphasis on the grants program does, however, raise a question about the extent of near-term stimulative economic impact that can be expected from the Federal sector. In our GNP projection, we assume that the reaction of the States to a rapid injection of additional grants would be to improve their shaky liquidity positions and to take off some of the pressure to raise taxes, rather than to increase spending immediately. Thus, we do not feel it appropriate to count revenue sharing on a dollar-for-dollar basis as additional short-run Federal stimulation, particularly since we are already projecting a sizable expansion in State and local outlays.

Turning to the revenue side, the economic impact of tax rates on balance would seem to be about the same in calendar year 1971 as in the last half of 1970, since the average level of tax rates remains unchanged. The increase in the social security tax rates (including an expected hike in the wage base) just about offset the recent reductions in both personal and corporate income tax rates. These latter

tax rate reductions came into effect in January as a result of personal income tax reductions legislated by the Tax Reform Act of 1969 and as a result of the Administration's recently liberalized depreciation rules on new purchases of capital equipment. For fiscal 1972 total tax revenues are projected \$4.2 billion smaller than in the Budget document--and the deficit correspondingly larger--but this reflects our weaker economic assumptions and thus does not imply any additional stimulative impact.

In summary, the staff projections of the Budget indicate a moderately stimulative fiscal policy. The rate of growth in total Federal spending is projected to be vigorous, but it is concentrated in the area of transfer payments and grants where the ultimate expansionary effects on GNP are less certain to be large. Effective tax rates, on balance, stay about unchanged during the current calendar year. Putting these elements together and making a further allowance for the normal growth in revenues that would be forthcoming if the economy were operating at full employment, a summary measure of fiscal impact is obtained in the high employment budget. On this basis the impact of fiscal policy does not appear to change much between calendar years 1970 and 1971. Using our own computation method, which smooths out the revenue effect of cyclical changes in the price levels, there is a slight deficit in the high-employment account in both of these years, and it is only in the first half of 1972 that there are signs of a larger deficit in the high-employment budget. Using the Council's method for calculating the high-employment budget, but incorporating our own spending projections, the high-employment surplus shrinks by \$2.5 billion from calendar year 1970 to 1971. Such a change is not large in a trillion dollar economy.

Despite this degree of near-term stability in the high-employment measure, I would judge the effect of the Budget to be moderately stimulative. If we assume that the private economy from here on out will benefit from the self-reinforcing effects of an economic upturn, the Budget--with the high-employment surplus at a low level in comparison to historical standards--should help contribute to economic expansion. The economy in the past has shown moderate economic recovery, such as in 1958 and 1961, despite a high-employment surplus that was both sizable and changing little. Moreover, in the

current setting, the normal cushioning effects of the automatic fiscal stabilizers--that result in large and growing actual deficits during 1971--will tend to brake tendencies in the economy that might otherwise produce cumulating weaknesses in some sectors of demand.

Mr. Wernick made the following statement regarding the staff's economic projections:

Taking into account the Budget outlook just discussed, and our expectation that financial markets will continue easy with an assumed 6 per cent rate of growth in money, the staff GNP projection still indicates that the upturn in 1971 is likely to be very moderate; that the gap between actual and potential economic growth will show no improvement; and that resources will continue to be considerably underutilized.

We have incorporated into our new projection some hedging of steel inventories in the first half of the year, a 60-day steel strike in the third quarter, and some rebuilding of stocks at the end of the year. The quarterly pattern of changes in Federal purchases has been made to conform with the new Budget and a 10 per cent increase in social security benefits.

The net effect of these changes is an erratic quarterly path of GNP growth in 1971, but on the whole the outlook is only a little stronger than in our other recent projections. We expect GNP to average about \$1,045 billion during 1971--about the same as before--but with the fourth quarter reaching a level of \$5 billion or so higher than projected previously. In real terms, the growth in GNP from the fourth quarter 1970 to the end of 1971 would be at an annual rate of 4.3 per cent, but this growth in part reflects the depressed situation in the final quarter of 1970. For the last half of 1971 real growth is projected to average about a 3.5 per cent annual rate.

A comparison of projected rates of growth for GNP and in key sectors of the economy from fourth-quarter 1970 to fourth-quarter 1971 with the cumulative changes for the four quarters following troughs in previous recovery periods, shows that our expectations are for a considerably weaker recovery than those achieved in earlier postwar cycles. Basically, the projected

recovery in real output is sluggish because we foresee neither a spurt in capital spending nor a surge in inventory investment comparable to those in past cyclical recoveries.

Plant and equipment outlays have been very high in relation to final output for an extended period. Moreover, capacity utilization rates in manufacturing are the lowest in a decade and the rise in profits this year seems likely to be moderate by past cyclical standards. Although liberalized depreciation schedules should bolster capital spending over the longer run, and may be having a small positive influence by late this year, we believe that the current incentives for increasing investment outlays are very limited. Thus, we project very little increase in business capital spending this year, and this provides no impetus to recovery.

Aside from the transitory influences coming from the auto and steel industries, there is also little to suggest that inventory accumulation will add appreciably to growth in the economy this year. In sharp contrast to previous recoveries, when there was substantial liquidation for at least two quarters prior to the trough, followed by large inventory building, the adjustment which seemed to be in process early in 1970 was both shallow and short-lived and recent quarters have shown continued over-all accumulation. Also, in the past substantial inventory rebuilding in consumer durables and capital goods industries has generally sparked the initial phase of the upturn. Now, however, ratios of inventories to sales and to unfilled orders in durable goods manufacturing remain very high; they are especially large in the capital goods and defense sectors. With some further downward adjustments in stocks expected in these industries this year, we do not foresee a buildup in inventories comparable to the earlier periods.

In a number of sectors of the economy, however, we have projected increases more in line with developments in previous recoveries. Housing activity, which has turned up so sharply in recent months, is projected to expand rapidly and to provide an important source of strength throughout the year. With savings inflows continuing very large and liquidity rebuilt, lending institutions are showing great interest in increasing their mortgage lending activities. In addition, government-subsidized housing is expected to be an

increasingly large factor in total residential activity. Although there is concern that housing demands could turn out to be less buoyant than now anticipated because of the high costs of building and financing, we think underlying demands are strong enough to support an increase in residential construction of nearly one-fifth in real terms between fourth-quarter 1970 and fourth-quarter 1971. This rise would be substantially greater than in the comparable periods of two of the three previous recoveries.

For State and local government spending, we have also projected a rapid expansion in real terms, about as large as in the previous recoveries, and perhaps too rapid given the financial problems faced by many of the governmental units. But this very large increase is projected to occur mainly in construction activity. It reflects the backlog of planned expenditures built up over the past two years, the continuing pressures for additional public facilities, and the much easier financing situation prevailing and in prospect.

The main hope for a stronger rebound in the economy this year seems to lie with the consumer. In the aggregate, consumer financial positions have improved, the saving rate remains high, and the stock market rise is a positive factor. But recent surveys continue to show consumer pessimism as the still dominant mood, and we expect that rising consumer prices, poor prospects for jobs and continued high unemployment will continue to dampen growth in consumer spending this year. The real rate of increase of 4.9 per cent in consumer spending would be less than in previous recoveries, even though we are expecting a sizable decline in the saving rate from its recent high levels. Therefore, it seems doubtful that business sales performance or expectations will improve sufficiently to fuel any upsurge in inventory and plant and equipment spending.

The implications of the slow recovery we have projected for resource utilization are rather gloomy. With industrial output moving up only slowly, capacity utilization rates are expected to remain around the current low rate of 73 per cent. And while we expect some gain in employment in the coming year, it is likely to be insufficient to offset growth in the labor force, in part because employers faced with persisting upward pressures on costs will probably continue to resist adding new employees.

Growth in the labor force this year should be fairly large. Additions to the working age population are heavily concentrated in young adult groups which have high labor force participation rates, and they are likely to enter the labor force regardless of existing job opportunities; in addition, 300,000 more men are scheduled to be released from the armed forces this year. Consequently, we expect the unemployment rate to rise somewhat further, and then to level off at about a 6.5 per cent rate later in the year.

The easing in labor markets should result in a further slowing in wage increases for nonunion manufacturing workers and for employees in less unionized industries such as trade and finance. But with prices continuing to rise, union bargaining this year will certainly try to match the large settlements obtained during 1970. While it is difficult to weigh these crosscurrents in wage movements, on balance we believe that the rise in average earnings may edge down slightly this year because of slack demands. But increases in output per manhour should be higher than in 1970 as real output picks up somewhat and businesses remain very cost conscious. Consequently, year-over-year increases in unit labor costs are expected to moderate to around 3.5 per cent by the fourth quarter of 1971, compared with a rise of over 5 per cent for 1970.

Comparing changes in unemployment with the GNP deflator, in the past when unemployment was in the 6 per cent range the deflator slowed substantially. But the increases projected for unit labor costs this year are still comparatively high and will continue to exert upward pressures on prices. Moreover, profit margins are expected to remain very low by historical standards, so that businesses will likely resist further absorption of cost inflation. Thus, we anticipate that increases in the GNP deflator will remain larger relative to the rate of unemployment than in past cycles. But with resources remaining underutilized, the price rise should moderate gradually throughout the year, and the deflator is projected to edge down to a 3.6 per cent rate of increase by the end of 1971.

Mr. Hersey presented the following statement regarding the balance of payments:

The prospects for the balance of payments this year are not bright. Along with the projected gradual recovery and continuing price inflation in this country, we assume a slackening of growth in business capital outlays in Europe and general demand and supply conditions much easier than they were at the beginning of 1970. In these circumstances we project a further narrowing of the U.S. trade surplus before 1971 is over.

Imports of materials already resumed their rise last year when supply conditions abroad eased. Of the projected 12 per cent rise from second half of 1970 to second half of 1971, about a third would be due to strike hedge buying of steel. Imports of finished manufactures (consumer goods and machinery) would rise more slowly, but they start from a level last year that looks extraordinarily high for a period of generally slack domestic demand.

The fact that price increases accounted for 6 or 7 percentage points of the 11 per cent rise in value of imports from 1969 to 1970 has a mixed meaning. On the one hand, it may suggest a developing improvement in our competitive position. On the other hand, the fact that despite the rise in prices we increased our real takings of imports 4 or 5 per cent in a recession year does make our competitive position look rather poor.

On the export side, advances in materials and machinery exports are expected to be small. Although we assume a renewed rise in industrial activity in most foreign countries, the pressures on resources there will be much less acute than they were at the beginning of 1970. With respect to other components of exports, a temporary boost to the export surplus early this year is expected from scheduled exports of civilian aircraft and from the recovery in auto component exports to Canada.

With these projections of exports and imports, the trade balance would average close to a \$2 billion rate in the first half year, but would shrink markedly after midyear as imports continue to rise.

Projected changes in service transactions and in military expenditures and sales require no special comment, except to call attention to the marked decline in investment income payments, as a result of the decline in interest rates. These payments drop from over a \$5 billion rate in the first half of 1970 to not much above a \$4 billion rate in the second half of 1971. With this and other changes in services, the net

export balance on goods and services combined should remain above a \$3 billion level throughout 1971, averaging about \$3-1/2 billion or about the same as in 1970.

In the private capital accounts the outlook is for substantially less total outflow than in 1970, if you include Euro-dollar repayments by U.S. banks. In the half year that ended not long ago we had a very rapid run-off in bank liabilities to their branches; this is being slowed by the measures the Federal Reserve and Export-Import Bank have taken.

In comparison with the second half of 1970 other capital outflows are likely to be larger rather than smaller. Unrecorded outflows of private U.S. funds had been very large in the first half of last year, under the influence of high Euro-dollar interest rates and expectations of the Canadian dollar's appreciation, but since midyear have been smaller. With U.S. interest rates relatively low and foreign currencies looking strong relative to the dollar, such outflows may increase again. The inflow of foreign buying of U.S. stocks resumed in June and became quite sizable in the second half of last year. Further gains in foreign buying of U.S. stocks are of course possible, but have not been included in the present projection.

Two sectors in which the projection does call for some improvement as compared with the recent past--perhaps overoptimistically--are U.S. bank credit to foreigners and U.S. buying of foreign securities. The fall in U.S. interest rates and easing of credit availability produced a large net outflow of bank credit near the end of last year, especially to Japan. We assume that VFCR ceilings, in conjunction with eventual declines in interest rates abroad, will prevent a continuation of so large an outflow. With regard to foreign securities, the Interest Equalization Tax will continue to prevent most new issues other than Canadian issues and World Bank issues.

Finally, one sector in which a worsening in comparison with the second half of 1970 is definitely to be expected is U.S. direct investments abroad. The capital expenditure plans of U.S. subsidiaries are still strong, interest rates abroad are high, and the restraints of the Office of Foreign Direct Investment have been relaxed a little.

Adding everything up, we cannot hope for an adjusted liquidity deficit this year below the \$3 to \$5 billion range. Some further run-off in total liabilities to

foreign branches of U.S. banks (after adding in liabilities of the Export-Import Bank) is very probable, especially in the next few months if there is not a marked easing of German and British interest rates. Therefore, an official settlements deficit of \$5 or \$6 billion or more seems to be in the cards for the year 1971, following 1970's deficit of \$10.7 billion.

Mr. Partee then concluded the presentation with the following comments:

The analysis we have presented this morning is admittedly on the gloomy side. We do not see the basis for a pronounced cyclical recovery of the sort envisioned by the Administration's target GNP of \$1,065 billion, mainly because we do not believe that the forces presently exist that would lead to a sharp turnup in inventory investment, to renewed expansion in capital outlays, or to real vigor in consumer spending so long as income generation remains sluggish. Nor do we expect a decline in the unemployment rate as the year progresses; on the contrary, we are projecting some further rise as a result of the sizable prospective increase in the labor force, further reductions in the armed forces, and continued acute cost-consciousness on the part of business. We are also not very optimistic about the further progress likely to be made in reducing the rate of inflation, since pressures for large wage increases remain intense, productivity gains are unlikely to be large in a sluggish recovery, and profit margins are already very low. Finally, the balance of payments picture is not encouraging, with net exports likely to be limited by a flattening of demands abroad plus some steel strike demand here, and with little basis for expecting a shift in our favor in capital flows other than Euro-dollars.

In an environment of the sort we are projecting, public policy would seem likely to come under increasing pressure to induce a faster and more substantial improvement in economic conditions. The problem, I fear, is that not a great deal can prudently be done. On the one hand, the factors that have led to our current difficulties--with inflation, with the balance of payments, and with a sluggish economy--have evolved over an extended period and may prove similarly stubborn to turn around. On the other hand, public policy has

already moved substantially in the direction of a stimulative posture. The Federal budget during 1970 already had returned to balance on a full employment basis, from a sizable surplus in the preceding year, and the new budget document indicates that spending will continue to rise at a pace equal to, or slightly in excess of, growth of full employment revenues over the year or so ahead. Monetary policy also turned stimulative a long time ago. Expansion in money supply amounted to 5-1/2 per cent in 1970, and the Committee's target of a trend growth of 6 per cent in money at recent meetings is, historically, relatively high. Interest rates have declined markedly in recent weeks and months, and financial markets have eased dramatically--to the point where banks and other lenders are now actively competing to find suitable borrowers.

The flow of funds projections consistent with our economic projections, and with continued 6 per cent growth in money, indicate that financial markets are likely to remain relatively easy in the year ahead. With market interest rates much reduced, savings should continue to flow into banks and other institutions at a relatively fast pace. We are projecting an increase of 9 per cent this year in bank credit, and of 8.7 per cent in thrift institution savings balances--in both cases a little slower than in the second half of 1970, when reintermediation was especially strong, but fairly large by earlier standards. On the borrowing side, we expect an increase in net funds raised this year to \$107 billion, mainly reflecting the sharp increase in Federal borrowing and in mortgage lending. The increase in the over-all borrowing rate from the second half of 1970, amounting to \$9 billion, can probably be accommodated readily by lenders, however, in view of growth in the dollar size of the economy--borrowing is estimated at 10.2 per cent of GNP--and of the continued monetary expansion assumed.

Markets for each of the main types of debt instruments should remain comfortable in 1971. In the Government market, the sharp increase in net Treasury issues will be offset by an equally sharp slowing in agency borrowing, and commercial banks are expected to continue as heavy net buyers. In the municipal market, we are projecting some decline in offerings from the very large 1970 second-half volume, and banks are likely to account for virtually all of the net acquisitions. In the corporate bond market, new issues are expected to drop off substantially as the year progresses, as the internal

funds available to corporations rise, and as banks compete more aggressively to extend longer-term credit to business. And as for the mortgage market, the need for investment outlets by banks, savings and loans, and mutual savings banks is likely to generate ample funds to meet prospective borrowing demands.

This situation leads us to expect generally declining interest rates during much of the year. So also does the predicted behavior of the income velocity of money. Based on our projected pattern of GNP growth and a 6 per cent rate of expansion in money, income velocity would rise very little before the fourth quarter of 1971. This pattern of change is notably different from earlier postwar cyclical recoveries, which leads me to believe that, unlike most other recoveries, there will be a lag before interest rates come under upward pressure. Our views on probable interest rate movements must of necessity be very tentative. We would expect a further decline over the next few months, on balance, in both long- and short-term rates. Sometime after midyear, short rates might turn upward again because of heavy seasonal Treasury financing and growing credit demands associated with the economic recovery. But long-term rates, as represented by new Aaa corporate yields, will probably continue to inch downward because of the expected dwindling of corporate offerings and further gradual moderation in the rate of inflation.

It remains to be asked how much additional economic recovery might be stimulated by more expansive monetary and fiscal policies. To test this, we have felt it necessary to extend our forecasting horizon beyond 1971 since there is not enough time in that interval for additional policy changes to work their effects. Judgmental projectors are hard pressed to extend their horizons even one year ahead, and so we have relied heavily on the use of our econometric model for 1972 numbers, tacking the results of that model--which are close to our staff projection for 1971 in any event--on to our judgmental base.

Using this partly econometric, partly judgmental, exercise, the first alternative projects key economic variables through 1972 on the assumption of a continuing 6 per cent growth in money and Federal budget expenditures for fiscal 1972 of \$235 billion. The second alternative adjusts the results for an assumed 7 per cent growth in money over the remainder of 1971 which subsequently returns to a 6 per cent rate of expansion. The third alternative includes both the 7 per cent monetary assumption and higher

Federal budget expenditures consistent with total outlays in fiscal 1972 of about \$240 billion.

Several points stand out in these results. First, even with the standard policy assumptions, real economic growth accelerates in early 1972 and the unemployment rate begins to decline. Second, adding in one or both policy changes adds noticeably to economic growth in late 1971 and the first half of 1972, and significantly reduces the unemployment rate, without adding appreciably to the rate of inflation. But economic growth tends to subside in the latter part of 1972 under all of the alternatives. What happens is that inventory investment accelerates and then levels off, while increasing outlays for business plant and equipment over the course of 1972 are partly counterbalanced by a leveling off in residential construction, which by then has experienced a large surge and may be approaching short-run industry capacity limitations.

The third point to be made about the alternative projections is that none of them, despite faster growth for a time--especially in the more stimulative policy versions--return the economy to anywhere near its long-term trend in output potential. In alternative 3--the one with the largest growth rate--output in real terms by the fourth quarter of 1972 is still nearly 4 per cent below potential (and unemployment is still above 5 per cent).

Now I will readily admit that our projections could be wrong in various respects. There may be more latent desire to accumulate business inventories than we believe, consumer spending may be potentially more robust than we have projected, and there could be both a greater demand and a larger output capacity in homebuilding than we now are estimating. But, even allowing for concentration of errors on the side of weakness, it is very hard for me to see enough unexpected strength to absorb this large margin of unused output potential. I therefore would favor a somewhat more stimulative posture in public economic policy, because I think that boldness in our present economic situation is needed and that it would involve relatively little risk.

The Chairman then suggested that the Committee turn to a general discussion of the economic and financial outlook. Apart

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from directing any questions they might have to the staff, he thought it would be desirable for the members to focus on any points at which they disagreed with the staff analysis.

Mr. Heflin noted that one of the assumptions made in the staff's GNP projections was that there would be a 60-day steel strike in the third quarter. He asked how developments would be affected if the strike did not in fact occur.

Mr. Wernick responded that he would still expect steel inventories to be liquidated in the third quarter as firms ran down stocks accumulated as a hedge against the strike, but not as rapidly as they would be in the event of a strike. The rate of over-all inventory investment in the fourth quarter probably would, therefore, be less than was now projected.

Mr. Partee added that the net effect on GNP would be an increase in the third quarter and a cut in the fourth quarter from the growth rates the staff was now projecting. By the end of 1971 the situation with respect to steel inventories should be about back to normal whether or not there is a strike in the third quarter.

Mr. Heflin said he also would like the staff's judgment as to whether the weakness in January in the demand for transactions balances--which he thought accounted for the relatively small growth in money then--was likely to continue in February and March.

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Mr. Partee noted that he had participated in the editing of the blue book^{1/} and accordingly was not in a position to offer an independent appraisal of the outlook for money growth. In general, it was clear that transactions demands for money balances varied with the state of the economy, but as yet little was known about the precise nature of the relationship. Obviously, transactions demands had been weak in January despite sharply falling interest rates--indeed, perhaps due in part to the rate declines, to the extent that anticipations of further declines induced investors to draw down cash balances temporarily. In any case, substantially increased demands for money appeared likely to emerge soon in connection with the expected first-quarter surge in GNP. That surge, in turn, seemed assured as a result of the resumption of production at General Motors. Accordingly, the staff was projecting stepped-up growth in money in February and March even at current interest rates.

Mr. Daane asked why the staff's projections allowed for little net increase in inventory accumulation over the course of 1971, even though 1971 was expected to be a year of recovery.

Mr. Wernick replied that the main reason for the projection of relatively little increase in inventory investment during 1971 was the fact that in 1970 inventories had not conformed to

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

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the traditional cyclical pattern of large-scale liquidation during the contractive phase of the cycle. Also, the ratio of inventories to sales and new orders was still high, especially in the business equipment, consumer durable goods, and defense industries; and with consumer spending remaining sluggish, it seemed unlikely that final sales would provide the impetus for a sharp build-up of stocks.

Mr. Daane remarked that if consumer spending should expand more than the projections suggested there might also be more of a pickup in inventory accumulation; and the two developments together could lead to a rather different picture of the recovery than portrayed by the staff.

Mr. Wernick commented that the staff had not intended to rule out such a possibility.

Chairman Burns suggested that it would be helpful if the staff were to work out an alternative projection on the basis of an assumption that consumer spending would rise a good deal faster than they now expected, and showing the implications for inventories and other sectors. Such an alternative projection would be particularly useful because of the high degree of uncertainty attaching to any forecast of consumer behavior.

Mr. Partee agreed that a projection of that type would be useful. He thought it was worth noting, however, that the present projection allowed for a rather sizable increase in

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consumer spending relative to income growth during 1971. The associated drop in the saving rate was larger than that experienced in other economic recoveries.

In response to a question from Mr. Daane, Mr. Wendel said he did not think that information on either the level or the rate of change in the high employment budget, taken alone, was sufficient for an assessment of the effects of fiscal policy; it was necessary to consider both. While the staff projected near-balance in the high employment budget in 1971, he had said in his prepared statement that the budget should help to contribute to economic expansion because near-balance would represent a stimulative posture relative to the surpluses recorded in 1969 and throughout the full cycles of 1957-59 and 1959-61. Of course, in interpreting the implications of a budget it was always necessary to consider the nature of expected developments in the private sector.

Mr. Kimbrel noted that the staff was projecting continuation of rather rapid flows of savings funds into banks in 1971. He was somewhat surprised by that projection because banks were already actively competing for loan customers and had begun to reduce the rates they offered on time and savings deposits. Moreover, the projected increase in consumer spending was expected to come in part from a reduction in the personal saving rate.

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Mr. Partee commented that the inflows to savings accounts were expected to remain relatively large because lower market interest rates--which had resulted in the heavy inflows of the second half of 1970--were expected to persist and perhaps drop somewhat further in the period ahead. He also noted that in formulating the projections consistency checks were made among related parts, so he felt confident in saying that there was no inconsistency between the projections of the over-all personal saving rate and of flows of savings to financial institutions.

At the same time, Mr. Partee continued, the flows into savings accounts projected for 1971 were somewhat smaller than those recorded in the second half of 1970, and they were much smaller than those in the third quarter of last year. That was partly because the stock-adjustment process reflected in the shifts of funds from equities to deposits in financial institutions that had been so important after mid-1970 was now believed to be largely completed. Such shifts, of course, affected the rate of growth in deposits only at the time they occurred. The fact that financial institutions were now considerably less eager than earlier to attract deposits also influenced the flow projections--although no explicit account had been taken of reductions in offering rates on deposits, which had not been widespread thus far.

Mr. Mitchell referred to Mr. Partee's final observation in his prepared statement to the effect that a more stimulative

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posture of public economic policy would be desirable and relatively costless. He asked whether Mr. Partee was recommending a more stimulative monetary or fiscal policy, and whether he was thinking in terms of stimulating particular sectors of the economy, such as the consumer or corporate sector.

Mr. Partee replied that he had intended to convey the view that the economic outlook was not particularly bright, and to stress the fact that the economy responded only gradually and with a lag to public policies. It seemed clear to him that, even if the staff's projections underestimated the strength of expansive forces, prospects were for a sizable shortfall from potential output and for an undesirably high unemployment rate; thus, he thought there was a good deal of room for increased economic activity. He had referred to public economic policies generally because he thought that both fiscal and monetary policy should be employed in stimulating the economy.

In his judgment, Mr. Partee continued, the main effort should be to encourage greater growth in consumption expenditures. A more rapid increase in consumer spending would help to correct the present problems in the area of business investment, including the underutilization of capacity and the squeeze on profits. Consumer spending could be stimulated most directly by appropriate fiscal policies, but monetary policy also could play a significant role. In general, a more rapid growth in the money supply and

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continued declines in interest rates could be expected to have a pervasive influence on the economy. There still were questions about the strength of the recovery in housing under present conditions with respect to interest rates and construction costs, and an easier monetary policy could help assure that the needed recovery would come about. Declining interest rates would help foster more positive business attitudes toward inventory accumulation; they would help State and local governments go forward with planned construction programs; and through a wealth effect they could have a favorable impact on consumer attitudes.

Chairman Burns said he might make a few comments on the Federal budget that had recently been released. He doubted that the budget would prove to be as stimulative as many people expected. His doubts arose not from the magnitudes of the figures, which were large--indeed, he would have wished for smaller figures--but from the heavy emphasis on the proposals for revenue sharing. He suspected that many observers had failed to think through the implications of those proposals.

What he had in mind, the Chairman continued, was not the doubts as to whether Congress would approve the Administration's proposals for revenue sharing. His thought, rather, was that if the proposals were approved the immediate effect on the spending of State and local government was unlikely to be strongly positive. That was because the State and local governments would have to make

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substantial readjustments in their administrative arrangements before they could take advantage of the new programs. Such readjustments could require a considerable amount of time, particularly since State legislatures often were not in session.

In response to a comment by Mr. Mitchell, Chairman Burns said he would agree that revenue sharing programs would be a stimulative factor over the longer run. His comments had been directed at the probable effects in the short run.

Mr. Brimmer said he was struck by the fact that the alternative policy courses the staff had set forth were associated with only modest differences in the expected course of economic developments during 1971. The extremes were represented by alternatives 1 and 3, with the latter calling for growth in the money supply during the year at a rate one percentage point faster than the former, and for \$5 billion more in Federal expenditures during fiscal 1972. In terms of expected outcomes in the fourth quarter of 1971, under alternative 3 the unemployment rate was only a shade below that under alternative 1, the rate of growth in real GNP was less than 2 percentage points higher, and the rise in the price deflator was the same. He thought the analysis would have been more useful if the staff had taken as a point of departure the Administration figure of \$1,065 billion for dollar GNP in 1971, and had considered the kinds of public policies that might be required to produce that outcome.

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Mr. Partee commented that the staff had looked into the kind of monetary policy that might be required to raise GNP by \$88 billion this year--from the estimated 1970 level of \$977 billion to a level of \$1,065 billion in 1971. There was a relatively short time interval in which to bring about a response in private spending to a policy change, so that it appeared that money would have to expand by something like 12 or 13 per cent in 1971 to produce the indicated growth in GNP. Such an alternative had not been included among those presented to the Committee simply because it seemed highly unrealistic.

Chairman Burns remarked that the staff's decision was a reasonable one. At the same time, there was merit in the argument that it was useful to consider not only the consequences of alternative feasible policy courses but also the policies that might be required to attain desired objectives.

Mr. Brimmer said he thought it would be helpful if the staff were to prepare an analysis of the implications of a GNP target of \$1,065 billion for the Committee's consideration at the time of the next meeting. Although he did not agree with that target, Committee members obviously would be confronted with it.

Mr. Partee remarked that, while he agreed that it was desirable to investigate both the implications of particular policies and the policies required to meet particular objectives, he was not sure that a study of the policies needed to produce a 1971 GNP level of \$1,065 billion would prove very

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useful. He would, however, be quite willing to work out for Committee consideration the implications of a set of public policies more stimulative than those set forth in the presentation today.

Mr. Maisel said he thought it would be useful to explore a different--although related--question; namely, the rate of growth in the money supply that would be required to validate an increase in GNP to \$1,065 billion in 1971, assuming that such an increase was brought about by exogenous factors.

Mr. Partee suggested that a 6 per cent growth rate for money was likely to be adequate for that purpose. Mr. Maisel responded that that might well be the case, but he thought it would still be useful to analyze the implications for velocity changes.

Mr. Coldwell asked whether the staff had not unduly downgraded the possibility that attitudes might develop which would lead to more consumer spending and more business inventory investment than the projections indicated. He thought spending might be increased either because people became more confident about the economic outlook or because they anticipated continued inflation.

Mr. Partee said it was true that the projections did not present a model of a confident economy. It was certainly possible that something might happen to enhance confidence and to produce

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rates of consumer and business spending that would take up some of the indicated resource slack, but the staff was not prepared at this juncture to predict such a development. He might note that if inventory accumulation were to reach the levels relative to total GNP that were recorded in the same phase of past cycles it would be at a rate of \$25 or \$30 billion in the fourth quarter, rather than the rate of \$6 billion the staff was projecting. He did not believe it was reasonable to expect a \$25 billion rate of inventory accumulation. As to anticipations of further inflation, in the past such expectations had usually led consumers to hold down their spending rather than to increase it.

Chairman Burns said he would agree with Mr. Partee's observation on the consequences of inflationary expectations in connection with the earlier stages of an inflation. However, spending behavior tended to change in the later stages of a strong, persisting inflation.

Mr. Swan remarked that if anticipations of continuing inflation tended to dampen spending, public policies intended to be stimulative might now have a perverse effect by adding to upward pressures on prices and thus encouraging inflationary expectations.

Mr. Partee replied that the inflationary pressures in the economy at present were mainly of the cost-push variety, except perhaps in a few sectors such as construction. In view

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of the slack in the economy, he would not expect that the additional output resulting from the kind of stimulative public policies he considered desirable would contribute to cost-push pressures or would create demand-pull pressures on prices over the next year or two.

Mr. Morris said he had some doubts about the staff's projections of State and local government spending, which implied a normal cyclical response in that area. He noted that in 1969, as a result of tight monetary policy, capital outlays by State and local governments had been dampened substantially for the first time in the postwar period. In view of that history it seemed reasonable to him to expect a stronger bounce-back this year than the staff had projected. Also, given the general monetary climate anticipated, he would question the staff's judgment that new offerings of municipal securities would not increase from 1970 to 1971.

Mr. Partee replied that both spending and securities offerings of State and local governments might well be somewhat higher than the projections suggested. The staff's assessment of the outlook for spending had been influenced by the difficulties that State and local governments apparently were experiencing in connection with their operating budgets. The projections did allow for a large increase in capital outlays. They also incorporated a substantial rise in compensation of employees, reflecting allowances for both an employment increase of 400,000

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to 450,000 and a sizable advance in pay rates. Other operating expenses were assumed to remain about unchanged.

Mr. Morris then said he would like to return to a subject Mr. Heflin had raised earlier--the change in the money stock in January. Apparently sizable advances had been recorded in that month in all of the monetary aggregates except M_1 . One possible reason for the shortfall in money was the fact that U.S. Government cash balances had increased substantially over the course of January--by about \$2 billion on a seasonally adjusted basis. According to calculations by his staff, M_1 plus Government balances increased at annual rates of 7 per cent from December to January and 7.2 per cent from October to January, compared with growth rates of 2.8 and 3.9 per cent, respectively, for M_1 alone. It seemed to him that unless the Treasury had suddenly become a hoarder of cash, the stage was set for rapid growth in private demand deposits and M_1 as the Government ran down its balances.

Mr. Axilrod commented that the relationship between short-run changes in Government and private demand deposits had been investigated repeatedly in recent years. While there were some differences of view within the System on the closeness of the relationship, he was not aware of any analyses suggesting that a given monthly change in Government deposits was necessarily associated with a roughly equal but opposite change in private demand deposits. The monthly changes were in opposite directions

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about half the time, but the orders of magnitude tended to be quite different.

With respect to January developments, Mr. Axilrod continued, it was true that Government deposits had risen by more than the staff had projected--about \$500 million on a daily-average basis, compared with an expected rise of about \$300 million. However, that difference of \$200 million was considerably less than the shortfall in M_1 , which was about \$600 million. On the whole, he thought the behavior of Government balances could explain some of the January shortfall in M_1 , but probably not more than a marginal amount.

In response to a question from Mr. Eastburn, Mr. Partee said the staff had no real basis for judging the extent to which the shortfall in M_1 reflected a shift from demand to time deposits in the public's asset preferences. The difficulty was that any such shift was likely to have been swamped by the much larger shift from market instruments to deposits. It was true that time deposits had expanded rapidly in January, but the further declines in market interest rates in that month were simultaneously giving investors an incentive to shift out of market instruments.

Mr. Mayo said he agreed with the Chairman about the likely short-run effects of revenue sharing, although he thought the question was academic since there appeared to be almost no chance

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of favorable action by the Congress this year. He also agreed with certain other observations that had been made in the discussion so far--specifically, that the policy alternatives presented by the staff were too narrow, and that consumer spending might well be stronger in the full year 1971 than the staff had suggested. At the same time, he wondered whether the projection for GNP growth in the first quarter might not be too optimistic, particularly if it was assumed that the output lost through the auto strike would be made up within the quarter. In his judgment the lost auto output would not be made up even over a considerably longer period. Perhaps an upward bias had been introduced into the first-quarter projection by mechanical aspects of the projection process.

Mr. Partee said he might note first that the projections for 1971 did not represent simply the results of a mechanical exercise. Rather, they reflected a judgmental process in which each category of the GNP accounts was considered separately. The projection for the first quarter--which, of course, was considered in more detail than those for subsequent quarters--was consistent with present expectations for retail sales, industrial production, and other major time series. The rise in dollar GNP now projected--about \$26.5 billion--was lower than the \$29 billion increase projected a month earlier, but

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admittedly it was still large. However, the \$26.5 billion figure did not reflect an assumption that the auto sales lost due to the strike would be made up in the first quarter; in light of the evident weakening in auto demand, it had been assumed that sales simply would return to the pre-strike annual rate of 8 million units. It was simply the case that a large amount of national product was generated by an increase in auto sales to that rate from the rate of about 5 million units prevailing during the strike, and by the additional GM production needed to restock dealer inventories.

Mr. Hayes said he was somewhat more impressed than the staff seemed to be by the possibility that the improved financial atmosphere--including the rise in stock prices--would have a favorable effect on consumer and business attitudes during the coming year. With respect to the projections of wages and prices, he wondered whether sufficient attention had been given to the complete lack of progress toward more moderate wage increases in the major wage settlements, including those of most recent date. Despite the Administration's great interest in the wage situation in the construction industry, he saw no real grounds for optimism there.

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Chairman Burns commented that while a great deal of optimism with respect to that area might not be justified, he personally thought there were grounds for some optimism.

With respect to the monetary aggregates, Mr. Hayes said he thought both the recent weakness of M_1 and the strength in time deposits were related to the sharp decline in interest rates, since investors would seek to lock up funds in interest-bearing deposits before the available yields fell further. Finally, with regard to the suggestion that the staff should investigate the policies that might be required to achieve some ambitious goal for GNP in 1971, he hoped that any such investigation would include an analysis of the implications for the balance of payments.

Mr. Daane said he could not view those implications with equanimity. He thought it would be helpful to have Mr. Solomon's views on the matter.

Mr. Solomon noted that Mr. Partee had indicated that the money supply might have to rise by 12 or 13 per cent in 1971 to foster a \$1,065 billion GNP in the year. Presumably the other monetary aggregates, such as M_2 , bank reserves, and the bank credit proxy would also expand sharply, and market interest rates would drop so precipitously as to make the declines of recent months seem moderate by comparison. The question, as he understood it, was whether the consequences for the balance of

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payments would be a matter of serious concern. In formulating his answer--and he was afraid it would not be a simple one--he would focus primarily on capital flows. In effect, he was assuming that the very rapid growth in GNP would not be associated with a significantly faster rate of price rise; if prices were to advance rapidly there obviously would be serious effects on the balance of payments.

If one were to take an optimistic approach, Mr. Solomon continued, he could argue that the availability of various selective measures designed to limit capital outflows made it unnecessary to worry at all about the balance of payments implications of the kind of monetary policy under discussion. For example, the recent security issue by the Export-Import Bank had seemed to meet with some success in slowing the repayments of Euro-dollar liabilities of U.S. banks. Serious consideration was being given to a second Exim issue, and a majority of the members of the Open Market Committee had agreed in principle that the System should undertake matched sale-purchase transactions if necessary in furthering that objective. He might also mention the interest equalization tax, the System's voluntary foreign credit restraint program, and the program of the Office of Foreign Direct Investment--all of which were directed at limiting, although not stopping, capital outflows.

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Mr. Solomon remarked that if one had faith in those devices he could view with equanimity the prospect of a sharp decline in domestic interest rates relative to those abroad. Unfortunately, money was fungible and large outflows could occur even with such devices in place. In 1969, for example, there had been a large outflow to the Euro-dollar market in response to a significant interest rate differential--but it occurred in unidentified form and was reflected in the balance of payments accounts under "errors and omissions." Thus, despite the control devices one should expect a decline in U.S. interest rates relative to those abroad to have deleterious effects on the capital account of the U.S. payments balance.

In his judgment, Mr. Solomon observed, that was a matter for concern although not necessarily for alarm. There were two main reasons for concern. The first was that large U.S. deficits would result in further accumulations of dollars by foreign monetary authorities, which could affect the stability of the dollar and raise the possibility--it was only a possibility--of some sort of international financial crisis that would hurt the interests of many countries. Secondly, as Mr. Daane had noted earlier, sharp declines in U.S. interest rates were disturbing to foreign monetary authorities because they led to undesired downward pressures on rates abroad. How seriously

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the Committee should take the resulting complaints was certainly a matter for debate; clearly, they could not be made an overriding factor in U.S. policy decisions. At the same time, they probably could not be ignored completely, since it was in the interest of this country to maintain harmonious relations with other countries.

In a concluding observation Mr. Solomon noted that the alternative policy courses being discussed had been formulated mainly in terms of a particular rate of growth in M_1 . He would like to suggest that the analytical basis for such an approach was shaky, to say the least. It was possible to define an expansive monetary policy in other terms, with quite different results.

With respect to Mr. Solomon's final comment Mr. Maisel remarked that the staff's projections seemed to involve relationships between changes in M_1 and other aggregates in the coming period that were similar to those prevailing historically. The implication was that no matter which aggregate the staff had used in describing alternative policy objectives the results would not have been affected significantly, since each aggregate could serve as a proxy for every other one.

Mr. Partee agreed, noting that he thought the stock adjustment process that had recently led to unusual relationships among the changes in various aggregates had nearly run its course. However, if an expansive monetary policy was

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defined in terms of some level of interest rates, rather than some growth rate for a monetary aggregate, he would agree that the outcome might well be different.

Mr. Francis observed that business statistics since early last fall were particularly difficult to analyze for underlying trends in view of the transitional effects of the General Motors strike. One approach was to bridge over the interruption by looking at trends from before to after the strike. Using projections based on the St. Louis Bank's research for the first half of this year, GNP was likely to rise at about a 6 per cent annual rate from the third quarter of 1970 to the second quarter of 1971. Growth of real product would be at about a 2 per cent annual rate during the same period. In the previous four quarters, GNP rose at a 4.6 per cent annual rate and real product decreased slightly. It appeared that the corner had been turned with respect to real product growth.

Also, Mr. Francis remarked, slow but continued progress was being made in moderating inflation. According to his staff's projections, over-all prices would rise at about a 4.5 per cent rate from the first quarter of 1970 to the second quarter of 1971. That compared with a 5.5 per cent rate of inflation in the previous four quarters. Employment, which declined in the last nine months of 1970, might be expected to rise somewhat in the first half of 1971 along with resumed growth

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of real output. Incidentally, there was little difference between the St. Louis Bank's projections and those implied in the green book for rates of change in GNP, real output, and the general price level.

In view of the great imbalances built into the economy by the excesses of 1965 through 1968, Mr. Francis said, recent economic developments had been about as good as could be expected. It would take time and patience to ameliorate the inflationary expectations and to correct the inequities created because some prices were more flexible and moved more rapidly than others.

Mr. Francis thought that monetary actions had been appropriately expansive in the past thirteen months. Since December 1969 the money stock had risen at about a 5 per cent annual rate, compared with 3 per cent in 1969. A broader measure of money, including time deposits other than large-denomination CD's, had risen about 8 per cent since a year ago, following a moderate contraction in 1969. Although movements in time deposits should not be taken as a measure of monetary influence because of the uneven impact of Regulation Q, the Committee might appropriately take note of the rapid expansion of that liquid instrument.

For those who judged monetary influence in terms of money market conditions, Mr. Francis observed, the System had been very expansive in recent months. Market interest rates had fallen markedly since early last year and borrowing from Reserve

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Banks had decreased by about \$600 million. Spending and production seemed to be responding satisfactorily to the Committee's expansionary monetary actions of the past thirteen months.

Chairman Burns remarked that he was a little more optimistic about the economic outlook than the staff was. That feeling was based on the finding from historical studies of business cycles that, once a recovery got under way, the forces of expansion usually developed great vigor at points that were not foreseen, and probably could not have been. At present the real question was whether a general recovery had started, and in his view that question could not yet be answered with any confidence.

The Chairman noted that little had been said this morning about the need for an incomes policy. He could report that he was more optimistic now than he had been earlier that the Administration would move in the direction of a meaningful incomes policy. The outcome of the discussions now under way with respect to the construction industry probably would indicate whether his judgment was correct.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period January 12 through February 3, 1971, and a supplemental report covering the period February 4 through 8, 1971. Copies of both reports have been placed in the files of the Committee.

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

Over the period since the Committee last met the narrowly defined money supply appears to have fallen short of the Committee's desires and staff expectations. Broader measures of the money supply, on the other hand, have expanded rapidly and interest rates in all maturity areas have declined markedly, partly in response to the easier money market conditions brought about by open market operations.

Interest rate developments--which saw the continuation of the sharp downward movement of the past several months--are covered in detail in the written reports to the Committee and there is little reason to dwell on them here. In general the declines ranged from about $3/8$ to $3/4$ percentage point or more. Some investor resistance to the lower rate levels emerged in the corporate and municipal markets as participants awaited the terms of the \$500 million AT&T issue offered today. Reoffered to the investor at 7.06 per cent, the issue has already been sold out, imparting strength to the markets generally. As far as Treasury bill rates are concerned, average rates of about 3.84 per cent were established in yesterday's regular bill auction for both 3- and 6-month bills, down about 80 basis points from levels established just prior to the last Committee meeting. The Treasury bill market is very strong this morning, with the three-month bill trading at 3.73 per cent.

With interest rates having fallen since mid-September by 1 to $2-3/4$ percentage points, depending on instrument and maturity, there is considerable uneasiness in the market about how long the decline in rates can continue. But with economic prospects uncertain, the budget outlook dim until Congressional spending plans are clarified, and market observers unsure how far the Federal Reserve intends to push its policy of ease or whether a further decline in the Treasury bill rate will be resisted by official action, there is no consensus as to the timing of a turnaround in rates. Generally speaking, the market tends to believe that some further decline in rates is likely, at least temporarily.

The Treasury refunding, conducted in an atmosphere of lower rate expectations and a comfortable money market, was very successful and a significant amount of debt extension was achieved. Looking ahead, the Treasury

will need to raise \$6 billion to \$9 billion by the end of the fiscal year. Unfortunately, the timing of these operations will be constrained by debt ceiling problems, and there is some possibility that the Treasury may have to resort to temporary direct borrowing from the System at some point. New debt ceiling legislation will be required--probably by the end of March or early April.

At the very outset of the interval, open market operations sought to achieve the somewhat easier money market conditions that the Committee felt desirable at the last meeting, bringing the Federal funds rate to 4-1/4 per cent. Early in the period, it appeared that M_1 was about on track, while the broader measures of money were running well ahead of expectations. As the period progressed, however, a significant shortfall developed in M_1 , bringing the January rate of increase on current estimates to about 2.8 per cent, only about half the 5.5 per cent target. As the shortfall became apparent, the Desk moved to achieve somewhat easier money market conditions, aiming first at a Federal funds rate of about 4 per cent or a shade below. Late last week, when data appeared to confirm a continued shortfall, we sought to achieve a 3-3/4 Federal funds rate, the lower end of the range felt desirable by the Committee at the time of the last meeting. As the blue book notes, the broader measures of money continued to run somewhat ahead of expectations, and despite the weakness of M_1 , those measures and the bank credit proxy showed significantly greater expansion in January than in the fourth quarter.

I should mention specifically the problem of the repurchase agreement rate with which we have had to struggle, and which has received a good deal of press attention. Until late in the period there was little need for a sustained supply of reserves for the banking system, making the repurchase agreement the ideal instrument for open market operations. The rate at which the System does RP's, however, has to be competitive with market rates. And these were being driven--as a direct result of policy implementation--progressively below the discount rate. As you know, the continuing authority directive permits an RP rate no lower than the New York Bank's discount rate or the latest average established in the regular 3-month bill auction. Consequently, in order to achieve reserve objectives, we lowered the RP rate, first to 4-3/4, then to 4-1/2, and finally to 4-1/4 per cent. Most sophisticated market

observers understand the technical necessity for an RP rate below the discount rate in times like these. But with our every action under close scrutiny for clues as to System policy intentions, each wiggle in the RP rate is inevitably interpreted by some as signaling a forthcoming change in the discount rate. This is unfortunate but unavoidable.

Looking ahead, the blue book sets forth three policy alternatives for Committee consideration, two of which would result--in varying degrees--in a further significant easing of money market conditions.^{1/} The blue book is quite specific--as it no doubt should be--in establishing a relationship between aggregate growth rates and money market conditions. But as we all know, these specifications often go astray. At the last meeting, for example, it appeared that a 5-1/2 per cent growth rate of M₁ would be achieved with a Federal funds rate of 5 to 5-3/4 per cent. And, as you know, in practice we couldn't come close to that growth rate even at a much lower Federal funds rate. Thus--depending in large part on the public's preference between narrowly defined money and liquidity--we might achieve a faster growth rate of money than the blue book indicates with little change in money market conditions. On the other hand, a 10 per cent growth rate for M₁ over the next two months might prove to be impossible no matter how far we ease money market conditions.

It appears to me that the Committee--perhaps even more than usual--is faced with a complicated choice of trade-offs, not only between growth rates of the aggregates and interest rates, but also among the various monetary and credit aggregates themselves. At the last meeting, the Committee placed somewhat greater weight than before on the credit proxy and on broader measures of money (which behaved well in January) but M₁ was still the dominant concern. It would be most helpful if the Committee in its deliberations would give some indication of the relative weights to be assigned to the monetary and credit aggregates now covered by the directive.

It would also be useful to know how far and how fast the Committee would like the Desk to react if M₁ (or some combination of aggregates) appears to be falling short of the Committee's desires. Generally we have tried to avoid

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

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moving money market conditions very far on short-run indications of a deviation from a target level, preferring to wait for some confirmation of the deviation, because of the erratic nature of the weekly statistics. Some members of the Committee may feel that the Desk has been slow to react to some of the recent shortfalls, and comment from the Committee on this point would also be useful.

Finally, we have the touchy point of short-term interest rate developments--particularly the Treasury bill rate--and the balance of payments. It would be helpful to know if the Committee would like to give special attention to the bill rate at this time. Looking ahead, with coupon issues available and the recent Treasury refunding not a major cause of concern, I would plan--if the Desk is called on to supply reserves--to buy some coupon issues rather than concentrate on Treasury bills. This might not be enough, however, to prevent further downward pressure on the Treasury bill rate, particularly if the Committee decides to move to easier money market conditions or if foreign central banks become large buyers of bills.

Chairman Burns asked if it was necessary to rely so heavily on repurchase agreements for reserve supplying operations at a time when RP's could be effected only at interest rates well below the discount rate. To his mind a differential between those two rates raised a troublesome question of equity in System dealings with Government securities dealers and member banks.

Mr. Holmes agreed that such a problem was created when RP's were made at rates below the discount rate. He thought, however, that it was necessary to rely on RP's to supply reserves when the needs to be met were highly temporary. The alternative--outright purchases of securities followed quickly by outright sales--could have a highly disturbing whipsaw effect on the market.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 12 through February 8, 1971, were approved, ratified, and confirmed.

Chairman Burns then asked Mr. Axilrod to comment on the monetary relationships discussed in the blue book.

Mr. Axilrod made the following statement:

The possible alternative strategies the Committee may wish to consider for the interval between now and the next meeting, described in the blue book, raise or imply three principal, and interrelated, questions. One has to do with how much weight to ascribe to the various monetary aggregates in setting targets for the Desk. A second relates to whether, and how rapidly, to move up to the previously targeted average level of the narrowly defined money supply in view of the shortfalls from path over recent months. And a third relates to the trade-off between monetary aggregates and money market conditions. With these three questions as a framework, I will try briefly to review some of the issues that the Committee may wish to consider in setting its policy approach for the next four weeks.

The blue book shows paths for four monetary aggregates--conventional narrowly defined money (M_1); more broadly defined money (M_2), which includes M_1 plus time and savings deposits other than large-denomination CD's at banks; the adjusted credit proxy; and total reserves. As among M_1 , M_2 , and the proxy, I would propose that the greatest weight still be given to M_1 , but that the behavior of other aggregates should be taken into account in Desk reserve operations.

The principal reason for relying on more than one variable would be the uncertainty that exists in economic knowledge as to the proper definition of money and as to the importance to be given to credit variables as against liquidity variables. But I still would take the view that we can be more confident in setting operating guidelines in terms of narrowly defined money than we can in terms of more broadly defined money or of bank credit, because the

behavior of M_1 is less influenced by the ebb and flow of intermediation. The behavior of money more broadly defined and bank credit is probably influenced more than that of M_1 by changes in the form in which the public saves in response to shifting interest rate relationships--with the actual behavior of broader aggregates depending on the interaction between the public's asset preferences and the aggressiveness with which banks seek to act as intermediaries in the savings process.

The projected behavior of M_2 is a case in point. It is expected to rise at an annual rate between 15-1/2 and 16-1/2 per cent in the first quarter. These would be rates of growth 4 to 5 percentage points higher than the highest achieved in any quarter back through 1964, as far back as our data now go and including some quarters when M_1 grew at rates between 6 and 9-1/2 per cent. Inflows of time deposits other than large-denomination CD's have been exceptionally strong in recent weeks, as the very sharp drop in market interest rates below ceiling rates probably led many savers to substitute time and savings deposits for market securities. But given the large inflows, one might expect banks to cut offering rates, as they now seemed to be in process of doing; and in any event net inflows might slow once consumers have adjusted to lower market rates.

Under the circumstances, a shortfall of M_2 from projections is evidently quite possible, and would simply reflect a return to a more normal condition for banks and the public. This is a reason for giving relatively little weight to M_2 in current circumstances. If weights had to be quantified in general, I would tend to attach something like two-thirds to M_1 and divide the remainder between M_2 and the adjusted credit proxy.

While limited in weight, M_2 and the adjusted proxy have grown rapidly enough in the fourth quarter and thus far in 1971 to justify, perhaps, the view that they provide some compensation for shortfalls in M_1 . But I would not have enough confidence that there has been a downward shift in demand for narrowly defined money at given levels of income to advocate considering the past shortfalls as water over the dam. I would still feel that shortfalls in M_1 are most likely to indicate that demands for goods and services are weak relative to the Committee's domestic

goals and that therefore lower interest rates are required to achieve such goals--with the appropriate level of interest rates coming into view as the Desk supplies the reserves adequate to attain the M_1 targets set at the past two Committee meetings.

This, of course, immediately raises the third question noted at the beginning--the trade-off between monetary aggregates and money market conditions. Often, of course, the question would not arise. But sometimes--as last spring and early summer--the Committee is willing to let the aggregates rise rapidly for a while should that prove necessary to moderate market pressures. And at other times the Committee may wish to consider moderating growth in the aggregates to reduce downward pressure on money market and short-term interest rates.

Should the Committee wish to moderate downward pressure on short-term rates under current conditions, it might be able to do so without giving up on its past M_1 target. Rather than fail to make up recent shortfalls, the Committee might extend the make-up period--as is suggested in blue book alternative B--and thus not cause as large a drop in money market rates immediately as under alternative A. But if the Committee wished to adopt the alternative B aggregate path, prudence would suggest moving immediately down into the lower 3 to 3-1/2 per cent range for the Federal funds rate indicated for this alternative, in view of the persistence of shortfalls over the fourth quarter and in January. At the same time, though, to attempt to moderate downward pressure on bill rates the Desk might be asked to concentrate its buying in coupon issues and its selling in bills. In the current psychological atmosphere, this might well accelerate long-term interest rate declines and thereby help hasten economic recovery--even while short-term interest rate declines are moderated once the market becomes convinced that the Federal Reserve, and perhaps Treasury debt management, will work to take the profit out of marking up bill prices.

Mr. Heflin asked whether market participants had become so accustomed to discount rate cuts of one-quarter of a percentage point that a reduction of one-half point would be interpreted as a signal that the System was rushing toward ease.

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Mr. Holmes said he thought the market had already discounted another one-quarter point cut.

Chairman Burns expressed the opinion that a one-half point cut would be interpreted as a significant move toward ease, an interpretation he thought the Federal Reserve probably would not want to foster. Moreover, the System had informally moved toward the practice of making more frequent but small changes in the discount rate. In the absence of strong reasons to the contrary, he thought it would be desirable to hold to that practice at present.

Mr. Mitchell said he wondered whether Mr. Axilrod, in commenting on the aggregates, had meant to imply that the Committee should place less than usual emphasis on money market conditions and interest rates at this juncture. On a related matter, the weights Mr. Axilrod had proposed for the various aggregates implied that he had considerably more confidence in M_1 than in M_2 as a guide to policy at present. Apparently Mr. Axilrod was downgrading M_2 because he thought inflows of time deposits might be smaller than expected as a result of reductions in bank offering rates. Personally, he (Mr. Mitchell) did not have as much confidence as Mr. Axilrod had in M_1 . As to the possibility of slackened inflows of time deposits, he thought the Committee should take account of such a development when it occurred but that it should not act now as if it were sure to occur.

In response to Mr. Mitchell's request for comment, Mr. Axilrod said his preference for M_1 over other aggregates as an operating variable was based as much on general considerations as on the particular circumstances of the moment. The behavior of the broader aggregates, such as M_2 or the bank credit proxy, was likely to be affected in unpredictable ways by such factors as shifts in asset preferences, changes in the aggressiveness with which banks sought CD and other time deposit funds, and large movements in market interest rates. In his judgment focusing primarily on M_1 was likely to lead to better monetary policy over the long run. With respect to current circumstances, he noted that the growth rate in M_2 now projected for the first quarter was unusually high. Shortfalls from the expected path for M_2 might well develop in the coming period if the expansion of time deposits proved to be less ebullient than now anticipated, and he doubted the advisability of calling for an easing of money market conditions for that reason alone.

The Chairman then noted that Mr. Robertson had to leave the meeting shortly to meet another engagement. He invited the latter to comment on monetary policy and the directive before departing.

Mr. Robertson made the following statement:

I believe we are presently at a juncture where we must weigh any further monetary policy moves especially carefully. I regret the recent shortfalls in the money supply, narrowly defined, below

our target path. But, as I have said before, I do not believe that measure should be our exclusive guide to policy. If we used it as such and, as a result, tried to push reserve injections as aggressively as we could in order to get M_1 inflated up quickly to our previous average target, we would, I believe, run a serious risk of overdoing on the side of ease and driving interest rates in the short run unsettlingly low (unsettling for both domestic and international reasons). This could create the real possibility that, as economic recovery starts to take hold, rates would snap back much more sharply than otherwise. The effect of such a sharp rise in interest rates in what would still be the tender stages of recovery could be most unhappy--both in terms of attitudes and expectations and in terms of sustaining the flow of funds to key sectors supporting the recovery (i.e., to the housing market and to State and local governments).

Apart from the statistics on the money supply narrowly defined, I think the indications are that our current monetary policy is very close to right. There are some signs of increases in spending which may lead to a resumption of better economic growth. Furthermore, the recent performances of M_2 and the bank credit proxy have been vigorous, largely because of the strong growth in consumer-type savings deposits. Such expansion underlines the large flows of funds now moving through the financial system into the housing and State and local government spending sectors, on which the strength of an early recovery depends so heavily. I think we should recognize these flows and to a large extent take credit for them; they are a key part of the salutary effect of our current accommodative policy stance.

As far as instructions to the Manager are concerned, I would continue to urge that he give progressively greater weight to M_2 as compared with M_1 . Specifically, I favor directing the Manager not to move to money market conditions substantially easier than those most recently prevailing, at

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least unless the aggregates fall below the levels which are associated with those conditions in the blue book. However, in view of the recent tendency towards shortfalls in the aggregates, I would counsel the Manager to resolve any doubts on the side of ease in his operations. These views lead me to favor alternative C of the draft directives (which calls for the maintenance of prevailing money market conditions, provided that the monetary and credit aggregates appear to be expanding at least as fast as projected).

I would also add that I would be prepared to follow the further downward movement that has taken place in short-term interest rates with reasonably early action to move the discount rate a notch lower.

Mr. Robertson then left the meeting.

Mr. Maisel referred to the earlier exchange regarding the aggregates between Mr. Mitchell and Mr. Axilrod and noted that Mr. Mitchell had also raised a question concerning the choice between aggregates on the one hand and money market conditions on the other for short-run target purposes. He (Mr. Maisel) thought it might be appropriate, in view of the existing lags, to consider the aggregates in terms of desirable growth rates over the whole period through June rather than on a month-by-month basis, and to focus on interest rates and money market conditions in the short run. Perhaps Mr. Mitchell had meant to imply the same suggestion.

Mr. Mitchell said he had had in mind the policy course associated with alternative C of the draft directives. He would not be distressed by a temporary deviation of the aggregates

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from the Committee's longer-run targets, although he would become concerned if the deviations persisted.

Mr. Axilrod noted that the specifications in the blue book for alternative C included first-quarter growth in M_1 at a 6 per cent rate. Since no effort to make up the fourth-quarter shortfall was called for, adoption of that alternative could result in a significant shortfall over the two quarters together from the Committee's longer-run target. He was concerned about the risk that the Committee might later find it could achieve its longer-run aggregative targets only by fostering extremely high growth rates over a short period.

Mr. Partee said the Committee might want to consider adopting the approach of alternative C--with specified money market conditions to be maintained in the absence of shortfalls from the associated growth rates for the aggregates--but apply the specifications given in the blue book in connection with alternative B rather than C.

Mr. Mitchell remarked that the differences between the money market conditions associated with alternatives B and C in the blue book seemed to him to be so small that it would matter little which the Committee specified. In any case, he shared the view that there was more than one useful way of appraising the

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monetary situation. At the moment, he thought a little more time was needed for the interest rate developments now in train to work their way through the financial markets.

Mr. Brimmer said he would like to return to the question of Government deposits that Mr. Morris had raised earlier. It appeared that such deposits had averaged about \$6 billion over the last four months of 1970, and that they had risen by roughly \$2 billion from the end of December to the end of January. If they now reverted to \$6 billion would there not be a large increase in the money supply?

Mr. Axilrod replied that it was preferable for present purposes to consider the rise in Government deposits from December to January on a daily-average basis, since that basis was used in calculating the changes in M_1 and other aggregates. As he had noted earlier, the daily-average rise in January was about \$600 million, and in his judgment it did not explain much of the short-fall in M_1 . Looking ahead, the staff was projecting a further rise in Government deposits from January to March of about \$600 million. For the same period the projections implied a considerable step-up in the rate of growth of M_1 . If Government deposits grew less than expected, or declined, there might be some feedback to the growth rate of the money supply.

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Chairman Burns then called for the go-around of views on monetary policy. He thought it would be helpful if in their remarks the members would address themselves to several questions. First was the question of whether a change in monetary policy was desirable at this time, and the related question of what directive language would best express the appropriate policy. Secondly, the Board would find it helpful to have the views of the Reserve Bank Presidents with respect to the discount rate. He might note in that connection that proposals from four Reserve Banks for reductions of one-quarter point, to 4-3/4 per cent, were now before the Board. The present discount rate was clearly out of line with market rates, and there were some reasons for moving promptly to reduce it. On the other hand, one could also advance some reasons for delaying action for a week or two.

Third, the Chairman continued, it would be helpful to the Board if the Presidents would express any views they might have concerning a possible reduction in reserve requirements. Additional reserves would be needed in the months ahead no matter what the Committee's general policy might be, and the question was whether those reserves should be supplied through open market operations or in part, at least, by reducing reserve requirements. Finally, the members might express their views on the proposal that the Desk should concentrate on coupon issues when buying securities and on Treasury bills when selling.

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The Chairman then invited Mr. Hayes to begin the go-around. Mr. Hayes said that in the interest of saving time he would summarize the statement he had prepared and submit the full statement for inclusion in the record. He then summarized the following statement:

We continue to be confronted by a set of circumstances calling for great caution in formulating monetary policy. The economy is by no means buoyant; indeed, it appears somewhat less vigorous than might have been expected in the wake of the General Motors strike settlement. At the same time, very little progress has been made in slowing the rate of inflation. The considerable fiscal stimulus provided by the current Federal budget seems appropriate to the present sluggish state of business, but I can see real danger of an excessively expansionary budget in fiscal 1972.

As we turn to international considerations, there is no doubt that the wide spread between domestic and foreign interest rates is having a severely adverse effect on our balance of payments and on European attitudes toward the dollar. On the official side, the growing doubts abroad with respect to the dollar are exemplified by the emerging feeling in some foreign countries that further creation of SDR's will have to be deferred until our payments deficit is reduced. More generally, there is considerable concern abroad that the U.S. has simply stopped paying attention to its balance of payments problems.

The most notable recent development with respect to the monetary and credit aggregates is the sharp contrast between unexpectedly slow growth in the narrow money supply and very generous rates of growth in all of the broader measures of money supply as well as bank credit. Interest rates have dropped very sharply throughout the financial markets since our last meeting, in good part because of our efforts to stimulate the flagging narrow money supply. The drop in interest rates over the last 12 months has been about as steep, I believe, as at any time in our history. It may be that the shortfall in money supply growth is less the result of a weaker than expected economy than of such

factors as a growing desire to hold liquidity in interest-bearing obligations, and perhaps a tendency to reduce compensating balances at a time when loan demand is low.

In sum, I feel that we have already produced a high degree of monetary ease as measured by almost all indicators except the narrow money supply, and I see no reason to push hard in the direction of further ease in the hope of reviving this flagging index--which may revive of its own accord. I would favor continuance of an "accommodative" attitude as set forth in the present directive, but I would also favor trying hard to hold money market conditions about where they are. I would not want to move toward easier conditions unless there were very convincing signs that economic recovery was not taking place or that monetary aggregates--including measures other than M_1 --are unexpectedly weak. The level of Treasury bill rates--in the light of international considerations--is a major factor arguing against further easing. Alternative C of the directive drafts would look about right to me, although I would prefer to amend one clause in the first paragraph to read "Interest rates have fallen sharply in recent weeks," rather than "Interest rates have fallen considerably further on balance in recent weeks." I would hope that the Federal funds rate could be kept around the 3-3/4 to 4 per cent level. I would be satisfied with net borrowed reserves close to zero or even modest free reserves. No doubt coupon-issue purchases might be used to a reasonable extent to help reduce downward pressures on bill rates.

As for the discount rate, it is again out of line with market rates and thus in a sense eligible for reduction merely by way of adjusting to realities of the market. I would hope, however, that the move could be delayed at least until after the middle of the month in order to minimize the growing impression here and abroad that the System is pushing hard for ever increasing ease.

Mr. Hayes added that he thought there were arguments both for and against a reserve requirement reduction. Providing reserves by that means would have the great merit of avoiding the downward pressures on short-term interest rates that would

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result from an equivalent volume of bill purchases. On the other hand, against the background of recent policy actions a near-term reduction in reserve requirements--particularly if timed closely with another cut in the discount rate--might lead to the cumulative impression that the System was moving toward monetary ease with excessive speed.

Mr. Morris said he did not think a change in policy would be desirable at this time. He was quite satisfied with the general performance of the aggregates in January and with recent developments in long- and short-term interest rates. As for the directive, he liked both the language of alternative B and the specifications associated with it in the blue book. Some members might consider alternative B to involve a change in policy, since it called for a 7 per cent rate of growth in M_1 over the first quarter, but at most it was a minor change.

As to the discount rate, Mr. Morris hoped the Board would approve a quarter-point reduction in the current week, since the 5 per cent rate was clearly out of line with market interest rates and a cut was widely expected. There had been considerable sentiment among the directors of the Boston Bank for a half-point reduction at this time. While he had persuaded the directors that a quarter-point cut would be more in line with the System's current philosophy, he was not sure they would remain persuaded if that cut were delayed too long.

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Mr. Morris said he would favor a careful exploration of the possibility of a reduction in reserve requirements. Such an action could be helpful in giving a more overt indication that the System was continuing to move in the direction of easing than was possible through open market operations. It might also be helpful in connection with the perennial problem of membership in the System. Finally, he thought the Manager should have continuing authority to operate in coupon issues on a modest scale when it appeared that such operations would serve a constructive purpose. However, he would be opposed to massive operations designed to tilt the yield curve. The experience with "operation twist" in the early 1960's suggested that such a policy would not be very productive.

Chairman Burns noted that coupon operations had been favored by some to minimize downward pressures on short-term interest rates for the sake of the balance of payments. One might question whether coupon operations would actually do much good in that respect but that would not be the same as saying they would do harm. He wondered if Mr. Morris thought such operations would be harmful.

Mr. Morris replied that the only harm that he could foresee was that which always resulted from undue interference with the mechanism of the market.

Mr. Coldwell said that for the directive he would favor alternative C, with the first sentence revised to read "...operations...shall be conducted with a view to confirming recent short-term money market conditions but accommodating additional downward pressures on long-term rates, while providing for continued growth in the monetary and credit aggregates." He would prefer to reduce the attention given to M_1 and increase that given to M_2 and the bank credit proxy; in fact, he would reverse the weighting pattern that Mr. Axilrod had recommended.

Mr. Coldwell remarked that he was reasonably satisfied with the general stance of monetary policy, but he had some questions about nuances in light of the kinds of problems that lay ahead. He would not favor an attempt to make up for the shortfalls in M_1 that had occurred. In response to a question the Manager had asked, he thought the Desk's reactions to the developing shortfalls in the recent policy period had been about right, given the terms of the directive under which it had been operating. He might note that if the Committee adopted the type of directive he was proposing, with its greater emphasis on money market conditions, the Desk would not have to react so quickly to shortfalls in the aggregates.

Mr. Coldwell observed that he would favor purchases of coupon issues and sales of bills, partly because of his concern

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with the balance of payments problem. He thought the discount rate should be cut to 4-3/4 per cent--preferably at the end of this week or early next week--if for no other reason than because the markets had already discounted such a move. Finally, he would not oppose a reduction in reserve requirements if serious problems were foreseen in supplying needed reserves through open market operations. However, he had some reservations about the desirability of such an action, because changes in reserve requirements had often been used in the past to signal major changes in policy.

Mr. Swan said he would prefer alternative C of the draft directives, although he would suggest making the language a little more positive by calling for the maintenance of "the easier money market conditions now prevailing," rather than simply for "prevailing money market conditions." Like Mr. Mitchell, he thought the difference between the specifications associated with alternatives B and C was not very great. If the Committee favored alternative B, he would hope that the language would be amended to refer to greater growth in "the monetary and credit aggregates" rather than in "the narrowly defined money stock." In his view more weight should be given to M_2 than to M_1 . Despite the shortfall in M_1 , he was satisfied with recent policy in light of the developments in the other aggregates and in interest rates. In the latter connection, he agreed with Mr. Hayes that some change was needed in the

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sentence regarding interest rates in the first paragraph of the draft directive. At the least, he would suggest dropping the words "on balance" from the clause reading "Interest rates have fallen considerably further on balance in recent weeks."

Chairman Burns asked whether there would be any objection to that change, and none was heard.

As to the discount rate, Mr. Swan continued, he believed that there was now rather general acceptance of the view that that rate should be kept in line with the market. He agreed that the changes should continue to be of one-quarter point. He thought, however, that the existing disparity with market rates argued not only for a prompt quarter-point cut but also for a readiness to consider another such cut before too long. He saw no reason to oppose operations in coupon issues, although he would share some of Mr. Morris' reservations if those operations were on a scale so large that the System could be said to be making the market. With respect to a possible reduction in reserve requirements, like some others he was not sure about appropriate timing. However, he did think something would be gained by elimination of the 1/2 point increase in requirements on demand deposits that had been made in April 1969.

Mr. Strothman said that at the beginning of today's meeting he had been undecided between alternatives B and C for the directive, but he now thought that B was the appropriate choice.

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With respect to the Chairman's other questions, he favored a prompt quarter-point reduction in the discount rate and he also thought this would be an appropriate time to reduce reserve requirements. He had no firm opinion at present on the desirability of operations in coupon issues.

Mr. Mayo observed that he also favored alternative B, which he would not interpret as involving a change in policy. However, he would modify the staff's draft by adding, after the reference to the objective of greater growth in money, some such language as "recognizing the recent shortfalls from the desired growth path." At the same time he would not want to set any specific time goal for making up the shortfalls.

Mr. Mayo said he favored fairly prompt action to reduce the discount rate to 4-3/4 per cent. He also favored a reserve requirement reduction in principle, but he considered timing important. In particular, he would not want to couple such an action with a discount rate reduction at the present time. Perhaps it would be best to postpone a cut in reserve requirements until a later point in the cycle, when reductions in the discount rate were no longer needed to maintain its alignment with market rates.

Although he shared some of Mr. Morris' reservations about the value of the original "operation twist," Mr. Mayo continued, he thought the present financial environment was quite different from that of the early 1960's. He believed that the Manager should

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have authority to undertake operations in coupon issues on a reasonable scale, in the hope that such operations would provide some benefit in connection with the balance of payments. He would oppose massive operations, however.

In a concluding observation Mr. Mayo said he would not be disturbed by a Federal funds rate as low as 3 per cent, if that proved necessary to come reasonably close to the Committee's target for M_1 .

Mr. Clay said that in the interest of time he would submit the statement he had prepared for inclusion in the record, and would confine his oral remarks to the questions posed by the Chairman. He believed that a change in monetary policy was not desirable at this time, and he thought that alternative C best expressed the policy course he favored. In his judgment a quarter-point cut in the discount rate was desirable at present and he planned to recommend such a cut to the directors of his Bank. Indeed, except for the desirability of moving in small steps he would be inclined toward a 1/2-point cut to keep the discount rate in closer alignment with market rates.

In his opinion, Mr. Clay continued, the practice of purchasing coupon issues and selling Treasury bills would serve a worthwhile purpose in connection with the balance of payments problem by reducing downward pressures on short-term interest rates. As he understood it, the Desk already had the authority to operate in that way. He had never been convinced that "operation twist"

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had done any harm and he believed it had done some good. He agreed that there was a problem of timing in connection with any proposed reduction in reserve requirements. When such action could be taken, however, it would be useful in helping to moderate downward pressures on short-term rates. It would also alleviate the problem of System membership. In that connection, he might mention a proposal currently before the Colorado legislature to eliminate all reserve requirements for State nonmember banks on public deposits, which were collateralized by Government securities equal to 110 per cent of their value. If that proposal was adopted it would represent an additional deterrent to System membership.

Mr. Clay's prepared statement read as follows:

The national economic situation appears to be essentially in line with the over-all view a month ago. There are variations in the pattern and prospects of some sectors of the economy, but the total picture has not changed markedly. The problems to be dealt with by public economic policy also remain much the same, including the need to stimulate economic activity and employment, restrain price inflation, and improve the international balance of payments. One factor to be taken into account is that fiscal policy appears destined to become more expansive during the year.

The difficulty of relying heavily on the M_1 money supply (or any other one factor, for that matter) as guide and target for monetary policy also continues, but the difficulty has been underscored by recent developments. There have been pronounced decreases in money and capital market interest rates to a degree that has given evidence of a very substantial movement toward ease. Monetary and credit aggregates generally, including bank reserves, bank credit, and the variants of the money supply except M_1 , have expanded markedly and also can be characterized as substantial movements toward ease. Both commercial banks and non-bank depository institutions have experienced strong increases in liquidity that have

brought some decreases in the interest rates that they offer and charge for funds.

Under the recent combination of circumstances, there has been a very large growth in time and savings deposits accompanied by a small growth in demand deposits in the commercial banks. That being the case, the M_1 money supply does not reflect adequately the impact of monetary and credit developments.

Looking ahead, it is difficult to see how the Committee can use the past and prospective growth of M_1 as the leading determinant of monetary policy as called for under draft policy alternatives A and B. If the program envisaged in either of those alternatives is chosen, it would need to be on the basis that the other effects of such an approach are justified in terms of credit markets, M_2 , M_3 , the credit proxy, etc., apart from the movement of M_1 , and the wording would have to be changed accordingly. Moreover, the Committee should not permit itself to become a prisoner of the current narrow public focus on M_1 , unfortunate though that may be.

Approached in this way, the policy selection appears more logically to be found in draft alternative C, basing policy upon the maintenance of prevailing money market conditions with a proviso clause that encompasses a range of monetary and credit aggregates in which M_1 would be only one of several factors to be considered.

Mr. Heflin said he thought that a change in monetary policy at this time not only was undesirable but could be dangerous. He favored alternative C for the directive. He noted that, according to the blue book discussion of alternative C, the maintenance of prevailing money market conditions would be associated with a first-quarter growth rate in M_1 of 6 per cent. To his mind that was "moderate" growth, or better, by any definition.

Mr. Heflin noted that he planned to recommend another quarter-point cut in the discount rate to the directors of the Richmond Bank at their meeting on Thursday. He would favor postponing a reduction in reserve requirements until such time as that action became necessary to moderate downward pressures on short-term

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interest rates. He thought it would be desirable to engage in a moderate volume of purchases of coupon issues, partly for the purpose of nudging long-term interest rates down. He agreed with Mr. Clay that the System's earlier effort of that kind had met with some success.

Mr. Mitchell observed that he preferred alternative C for the directive, but he could also accept B or the wording proposed by Mr. Coldwell. He found either B or C acceptable partly because, as he had indicated earlier, he thought the difference in the money market conditions associated in the blue book with those alternatives was not very great. In particular, he thought the two ranges given for the Federal funds rate--3 to 3-1/2 per cent under alternative B and 3-3/4 to 4 per cent under C--were not sufficiently far apart to permit a confident prediction that they would be associated with markedly different growth rates in M_1 . There might be some merit in the language of B from the point of view of public understanding of the Committee's stance, but otherwise he thought that alternative had no particular advantage over C.

With respect to the draft of the first paragraph of the directive, Mr. Mitchell noted that the opening sentence asserted that economic activity was "rebounding" in the first quarter with the resumption of higher automobile production. He thought that statement was potentially misleading.

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Other members concurred in Mr. Mitchell's observation. After discussion it was agreed that the statement should be revised to indicate that activity was "rising...primarily because of the resumption of higher automobile production."

Mr. Mitchell went on to say that he favored operations in coupon issues and would not suggest any explicit limit on such operations. He thought there was no risk in telling the Manager that he could go as far as he liked in that regard, because he was confident that the Manager would not go as far as he (Mr. Mitchell) would consider desirable.

Mr. Daane remarked that he was disturbed by the inference he drew from the current blue book that the only important question in formulating monetary policy was the appropriate growth rate for M_1 , with no need to consider the causal relationships at work. Earlier in today's meeting Mr. Axilrod had expressed the view that the recent shortfalls in M_1 were due to a deficiency in demand. He (Mr. Daane) was concerned with that deficiency, but he thought it should be recognized that monetary policy operated through the cost and availability of credit. In those terms, he believed that the Committee had gone about as far as it should, except that he would like to see some further reduction in long-term interest rates. In his judgment short-term rates had declined about as far as would be desirable in light of

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international considerations, and the aggressiveness with which banks were seeking loan customers suggested that there was no problem with respect to credit availability.

In sum, Mr. Daane observed, he would not favor a change in policy at this time. He favored alternative C for the directive with the modification proposed by Mr. Coldwell. That modification seemed helpful particularly in the addition of a reference to the desirability of continuing declines in long-term rates.

Mr. Daane said he would be reluctant to reduce the discount rate at this juncture. In the discussions at Basle last weekend both he and Mr. Coombs had made the point that recent declines in short-term rates in the United States had not been caused solely by Federal Reserve actions but had also reflected the weakness in aggregate demands. A cut in the discount rate now probably would have little impact on the domestic availability of credit or even on its cost. On the other hand, it might well be interpreted abroad as signifying that the System intended to disregard the wishes of the monetary authorities of other countries that had been set forth with such force and unanimity at Basle. He would not suggest that those wishes should be binding on the System, but he believed that they should be taken seriously. For that reason, he would hesitate to reduce the

discount rate immediately in the absence of a need for such action from the standpoint of the domestic economy. He thought it might be better to act later, and to make a larger cut if that appeared desirable in light of the economic conditions prevailing then.

Mr. Daane added that he would not favor a reduction in reserve requirements at this time. He would want to have the Desk emphasize coupon operations as much as possible, partly to encourage some further decline in long-term rates. He did not believe such operations would be counter-productive.

Mr. Maisel remarked that in terms of policy for the longer run he favored the second of the three alternatives Mr. Partee had described, which involved growth in M_1 at an annual rate of 7 per cent. In his judgment the pattern of economic activity expected under that alternative should be taken as the minimum goal; hopefully, exogenous factors would result in more rapid expansion.

Unlike Mr. Daane, Mr. Maisel continued, he thought it was important that the Committee specify a target in terms of M_1 . However, as he had indicated earlier, he would consider it desirable to work toward the indicated growth rate of 7 per cent over the first half of 1971 as a whole rather than on a short-run basis. He agreed that there was considerable uncertainty about the money market conditions that would lead to particular

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growth rates for money, and while he favored some easing of money market conditions in the current period he would not want the easing to proceed too far. Specifically, he would like to see the funds rate lowered into the 3 to 3-1/2 per cent range associated with alternative B in the blue book, but not pressed below that range for the time being even if further shortfalls from the target path for M_1 appeared to be developing. On the other hand, in view of past shortfalls, he would not want to see the money market tightened if it appeared that M_1 was growing at rates above the target path.

Mr. Maisel said he preferred alternative B for the directive. He thought the Manager should engage in coupon operations to the extent that he considered feasible.

Mr. Brimmer observed that he saw no need for a change in monetary policy at this time and therefore favored alternative C of the draft directives, preferably with the modifications suggested by Mr. Coldwell. He noted that in commenting on the possibility of a reduction in reserve requirements several Reserve Bank Presidents had mentioned the potential benefits in connection with the problem of System membership. He thought they might also want to consider the similar benefits that would flow from adoption of the basic borrowing privilege included in the proposed redesign of the discount mechanism.

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Mr. Brimmer remarked that he would not want to see the Federal funds rate go below a 3 to 3-1/2 per cent range. He would support the purchase of coupon issues, although perhaps not quite in the volume favored by Mr. Mitchell. In response to the Manager's question, he thought the Desk's reaction to the recent shortfalls in M_1 had been about right. He might also note that he was not disturbed by the need from time to time to make repurchase agreements at interest rates different from the discount rate.

With respect to the first paragraph of the directive, Mr. Brimmer suggested that it would be desirable to include references both to the widening differential between interest rates at home and abroad and to the recent Export-Import Bank security issue and its impact on Euro-dollar flows.

Mr. Sherrill expressed the view that the economy was suffering principally from a lack of confidence and that it was important for the Federal Reserve to do what it could to strengthen confidence. Activity was moving upward at desirable rates in a few sectors of the economy, chiefly housing and State and local governments. However, the same could not be said about other sectors. In particular, the spending behavior of consumers following the auto strike had been quite disappointing. It seemed unlikely that business spending on inventories or fixed

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investment would pick up until there had been a revival in the consumer sector.

Mr. Sherrill noted that a further reduction in interest rates could help to foster the needed revival. While too much of a drop in rates could stimulate a resurgence of inflationary expectations, on balance he thought that rates should be lowered another notch. Accordingly, for the directive he favored alternative B, which called for a relatively modest rate adjustment.

From the point of view of monetary policy, Mr. Sherrill continued, he considered the growth rate in M_1 to be less important at the moment than the level of interest rates. But the short-run money growth rate took on added importance simply because of the stress being placed on it by Administration officials and members of Congress. That consideration also argued for adopting alternative B today. With respect to the longer run, he agreed with Mr. Maisel that it would be desirable to achieve a money growth rate of about 7 per cent over the first half of the year. If that would represent a change in policy, he should be recorded as favoring a change.

Mr. Sherrill added that he would support the purchase of coupon issues to the extent the Manager thought was feasible,

The meeting then recessed and reconvened at 2:30 p.m. with the same attendance as at the morning session.

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Mr. MacDonald expressed the view that the present course of monetary policy was appropriate. He noted that he had supported the targets adopted at the last meeting, which were designed to make up the shortfall in the money supply experienced in the fourth quarter of 1970. The most recent projections indicated another shortfall in the money supply for February and for the first quarter. Today, he would support a directive that would call for an attempt to push the money supply back on the target path, but in a gradual effort that would not lead to a snap-back in money market rates. If loan demand remained weak, the Committee might be forced to accept some shortfall for a while in the narrow measure of the money supply, and be satisfied with rapid expansion in bank credit and the broader measures of the money supply. He favored alternative B of the draft directives.

In response to the Chairman's other questions, Mr. MacDonald reported that he would be recommending a quarter-point reduction in the discount rate to the directors of his Bank. He observed that, while he thought a reduction in reserve requirements could be useful in the present situation, he shared the reservations of many Committee members about the timing of such a move. Finally, he saw no reason for opposing the purchase of coupon issues, and he believed that the timing and amounts involved should be left to the judgment of the Manager.

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Mr. Eastburn said he did not favor a change in monetary policy at this time. He thought alternative C of the draft directives best expressed the policy course he had in mind, although alternative B also would be acceptable to him. In his judgment alternative A was undesirable because of the excessive market disturbance that was likely to result from an attempt to make up the recent shortfalls in M_1 in a brief period.

With respect to the discount rate, Mr. Eastburn said he would like to see a quarter-point reduction as soon as possible, possibly followed by another quarter-point cut reasonably soon thereafter. Like others, he had mixed views on the desirability of a reserve requirement reduction. On the one hand, such a move would give a stronger signal of monetary easing than he thought would be appropriate at the present time. On the other hand, the System did have some structural problems that it would be desirable to deal with. He hoped that when a cut in reserve requirements was made it would be designed in a way that would improve the situation with respect to System membership. He would support purchases of coupon issues at the discretion of the Manager, although he was not very optimistic about the results.

Mr. Kimbrel said he considered the current stance of monetary policy to be about right and saw no compelling reason to make a change. If he had a vote he would favor alternative C

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for the directive, in the form proposed by the staff. He would view a quarter-point cut in the discount rate as appropriate, but would prefer to have it made early next week. On the subject of reserve requirements, he recalled that he had suggested at the December meeting that the time was approaching to consider a reduction. He thought such a move would be desirable for both of the reasons that had been advanced today, but he was particularly interested in the contribution it would make in the area of member bank relations. He had no objection to continuing the Manager's authority to engage occasionally in probing operations in the coupon market, but he thought it was likely that sustained, heavy purchases of coupon issues would be misunderstood.

Mr. Francis said it seemed to him that the 5 per cent rate of growth of money prevailing since December 1969 had been appropriate and had been achieving desirable results. He favored continuation of such a rate in the near future, beginning now. He believed it would be a mistake to try to achieve some great jump of the money stock in the near future. A 5 per cent rate of growth, up moderately from the 3.4 per cent rate of the past three months, would be appropriate. According to the estimates of his staff, such a policy would result in further acceleration in growth of real output, and a continued modest reduction in the rate of inflation--to below a 4 per cent annual rate at year-end.

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In view of the monetary expansion in the past year, and in view of the lags of effect, it seemed to him that a still more rapid monetary expansion now would incur a high risk of overheating the economy and intensifying inflationary pressures.

Mr. Francis remarked that he was unhappy about each of the three proposed alternatives for the directive. Each contemplated a rate of growth of money greater than he considered prudent, and alternative C had the further demerit of putting chief emphasis on money market conditions. He suggested that in the future the Committee place less emphasis on money market conditions in policy implementation. Once again in 1970 the Committee had found that reliance on changes in measures of money market conditions was not satisfactory as a means for controlling the rate of monetary expansion. Monetary expansion during the past year had been most rapid when interest rates were relatively stable or rising, and slowest when rates were declining.

Mr. Francis went on to say that he favored an early quarter-point reduction in the discount rate and he believed that over the longer run the System should work toward lower reserve requirements. He suggested that thought be given to the possibility of combining a cut in reserve requirements with a return to a 3-day deferment schedule on check collections, thereby eliminating much of the present volume of Federal Reserve float.

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He saw nothing wrong with purchases of coupon issues as a means of supplying reserves, but he would not be enthusiastic about a program in which purchases of long-term issues were coupled with sales of Treasury bills.

Chairman Burns remarked that the Committee's discussion had been quite useful. There was a clear consensus to the effect that the Desk should engage in operations in coupon issues on a responsible scale. As to the directive, a majority of the members favored alternative C or some variant thereof, and a minority favored alternative B; no one had expressed a preference for A.

Personally, the Chairman continued, he believed that monetary policy had been basically sound over the past year, and he had no quarrel with the policy of the last few months. However, the shortfalls from the Committee's targets for the monetary aggregates that had occurred had caused difficulties for the System, and further shortfalls would cause continuing difficulties. He did not agree with those who thought that some particular growth rate in the narrowly defined money supply in 1971 would insure a strong economic expansion this year, and in his judgment the heavy emphasis that many people were placing on the behavior of M_1 involved an excessively simplified view of monetary policy. But however unfortunate such views might be, the fact that they were widely held had consequences for the System.

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For today's directive, Chairman Burns continued, he would favor a modified version of alternative C. Like others, however, he thought there were some problems with the staff's formulation of that alternative. In particular, he was concerned about the risk that it might lead to another possibly avoidable shortfall in the monetary aggregates, insofar as it encouraged the Desk to rely on projections rather than on the latest available statistics in deciding whether the aggregates were on the target paths. Experience indicated that such projections could be highly misleading, and that relying on them could result in undesirable delays in the Desk's reactions to incoming evidence of shortfalls.

The Chairman noted that he had asked the staff during the luncheon recess to reformulate alternative C, taking account both of suggestions made in the Committee's discussion this morning and of the difficulties he saw in the original draft of C. Their new formulation, which seemed generally satisfactory to him, read as follows:

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to confirming recent short-term money market conditions while accommodating additional downward pressures in long-term rates; provided that money market conditions shall promptly be eased somewhat further if it appears that the monetary aggregates are falling short of the more rapid growth path projected.

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If the Committee were to approve such a directive, Chairman Burns said, he would propose that it be interpreted along the following lines. First, during the statement week beginning February 11, the Desk should continue to aim at a Federal funds rate of $3\frac{3}{4}$ per cent. If the response of the aggregates appeared to be inadequate--that is, if there were any indications that the aggregates were falling below the paths shown in the blue book under alternative C--during the following statement week the Desk should aim at a $3\frac{1}{2}$ per cent funds rate. If the response of the aggregates was still inadequate, the Manager should promptly call that fact to his (Chairman Burns') attention. He would then decide whether circumstances warranted calling for a telephone conference meeting of the Committee or a special Washington meeting to review the situation.

The Chairman proposed that in evaluating the behavior of the monetary aggregates the Manager should give equal weight to M_1 and M_2 . Finally, in view of the large shortfalls that had occurred in recent months, he thought the Manager should not seek to tighten money market conditions even if the aggregates turned out much stronger than the projections associated with alternative C in the blue book.

The Chairman then called for discussion of the directive language and specifications he had proposed.

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Mr. Mayo said he found quite satisfactory both the specifications and the general approach to operations that the Chairman had outlined. With respect to the directive language, he would prefer to delete the words "more rapid" from the final phrase.

Mr. Daane concurred in that language change and suggested also that the concluding word, "projected," be replaced by "desired." The last part of the paragraph would then read "...if it appears that the monetary aggregates are falling short of the growth path desired."

There was general agreement to those proposed changes in wording. There also was agreement to a subsequent suggestion by Mr. Brimmer to replace the phrase "confirming recent short-term money market conditions" with "maintaining prevailing money market conditions," and to a suggestion by Mr. Coldwell to replace the word "pressures" with "movements" in the phrase "downward pressures in long-term rates."

Mr. Daane asked how the Manager would be expected to interpret the instruction to give equal weight to M_1 and M_2 if those aggregates diverged from the target paths in opposite directions.

Chairman Burns noted that the Committee had been trying in recent months to increase the degree of specificity in its

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instructions to the Manager, and that the latter was eager to have additional guidance. However, there was a point beyond which such efforts should not be carried. He (Chairman Burns) would be inclined to leave the question Mr. Daane had posed to the judgment of the Manager. If the latter asked for his advice, he would suggest that in the event of disparate movements the magnitudes of the deviations should be taken into account.

In response to questions by several members, the Chairman said he was proposing that the Manager should not aim at a Federal funds rate in excess of 3-3/4 per cent in the coming period no matter how strong the aggregates were, nor at a funds rate below 3-1/2 per cent--at least without further instructions from the Committee--no matter how weak the aggregates were. He was also proposing that the Manager should move promptly to a 3-1/2 per cent funds rate at the end of the coming statement week if it appeared that the aggregates were running below the target paths--and not wait two or three weeks longer for confirmation of the shortfall. Of course, the Manager could not be expected to maintain the funds rate precisely at any particular level, and the actual rate might deviate in either direction from that desired for two or three days at a time.

Mr. Daane asked for the Manager's view of the possible implications for international short-term rate differentials of a reduction in the Federal funds rate to 3-1/2 per cent.

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Mr. Holmes replied that, as he had mentioned earlier, the Treasury bill rate had been moving down fairly rapidly recently and had declined further today. The differential had been widening lately, and unless there were parallel reductions in rates abroad it could widen further. At the moment the market was particularly sensitive to any clues regarding the System's policy intentions. It was only yesterday that market participants had concluded that the System was aiming at a Federal funds rate below 4 per cent, and he would expect some reaction if they were to conclude that the target rate had been reduced to 3-1/2 per cent.

Mr. Daane remarked that the risk of wider international rate differentials gave him pause in contemplating the possibility of a 3-1/2 per cent Federal funds rate. Perhaps it would be best to hold to the current target of 3-3/4 per cent rate for the time being, even in the event of shortfalls. He noted that 3-3/4 per cent was below the rate that had been prevailing until very recently.

Chairman Burns commented that while the System was faced with international as well as domestic problems, the latter were the more pressing. Moreover, special tools were available for dealing with the former, even though--as Mr. Solomon had pointed out--they had their limitations. At present there was a significant risk of another month of shortfalls in the monetary aggregates.

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While such shortfalls might result from forces beyond the control of the Federal Reserve, he would not want to increase the risk of their occurrence by deciding to delay a response to any indications of weakness in the aggregates. The move he proposed in the event of such indications--from a 3-3/4 to a 3-1/2 per cent Federal funds rate--was quite modest by any standard.

Mr. Hayes said he would agree that a quarter-point reduction in the target for the funds rate would be a modest step. By the same token, however, he did not think it could be expected to have much effect on the growth rates of the monetary aggregates. Also, he doubted that it was possible to make a meaningful assessment of the performance of the aggregates within a period as short as a week, or even in three or four weeks. For that reason he would prefer to delete the proviso clause relating to the aggregates from the directive under discussion, although he could accept the directive with that clause included.

Mr. Sherrill expressed the view that it was highly desirable to include a reference to the aggregates in the directive.

In response to a question by Mr. Francis, Mr. Holland noted that the target paths for the aggregates under the proposed directive--those associated with alternative C in the blue book--involved growth rates for M_1 of 6 per cent over the first quarter and 9 per cent from January to February.

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Mr. Francis said he would find it necessary to dissent from the proposed directive.

Mr. Maisel said he planned to vote in favor of the proposed directive. However, he thought it was worth noting that under the alternative C target path the level of M_1 in the week ending March 10 was the same as the level in the week ending February 10 under the target path the Committee had approved at its previous meeting. Thus, if the Committee adopted the alternative C target today it would in effect be moving the desired M_1 growth path forward by a month; that is, M_1 would reach the February 10 level a whole month later.

Mr. Daane said he could accept the proposed formulation for the directive; it certainly seemed preferable to any of the alternatives the staff had submitted earlier. But whatever the directive language, he thought the Committee incurred some important risks when it tied itself too rigidly to specific targets for the monetary aggregates. He suspected that it might not prove possible to achieve growth rates in M_1 of the order the Committee had recently been seeking until an economic expansion was well under way.

Mr. Holland noted that, in addition to certain modifications of the staff's draft of the first paragraph of the directive on which the Committee had agreed earlier, Mr. Brimmer had suggested the inclusion of references to international interest

rate differentials and the recent security issue of the Export-Import Bank.

After discussion, the Committee agreed on specific language for the references Mr. Brimmer had proposed.

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, which declined in the fourth quarter of 1970, is rising in the current quarter primarily because of the resumption of higher automobile production. The unemployment rate remained high in January. Wage rates in most sectors are continuing to rise at a rapid pace, and recent increases in some major price measures have been relatively large. Interest rates have fallen considerably further in recent weeks despite continued heavy demands for funds in capital markets, and differentials between interest rates in the United States and those in major foreign countries have widened further. Federal Reserve discount rates were reduced by an additional one-quarter of a percentage point to 5 per cent. Bank credit increased considerably further in January, as business loan demands strengthened somewhat and banks made substantial further additions to their holdings of securities. The money stock narrowly defined grew modestly in January following a stronger December rise, but money more broadly defined expanded sharply further as a result of continued rapid growth in consumer-type time and savings deposits. The over-all balance of payments deficit in the fourth quarter was about as large as in the third quarter on the liquidity basis; on the official settlements basis the deficit increased further from the very high third-quarter level as banks continued to repay Euro-dollar liabilities. More recently, the issuance of a special Export-Import Bank security

to foreign branches of U.S. banks helped to moderate the flow of dollars to foreign central banks. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining prevailing money market conditions while accommodating additional downward movements in long-term rates; provided that money market conditions shall promptly be eased somewhat further if it appears that the monetary aggregates are falling short of the growth path desired.

Chairman Burns then suggested that the Committee discuss a memorandum from the Secretariat dated November 5, 1970, and entitled "Possibility of reducing time lag for the publication of FOMC policy records from 90 to 60 days."^{1/} He asked Mr. Broida to comment.

Mr. Broida noted that the staff had examined the possibility of reducing the time lag at the suggestion of Mr. Brimmer. As noted in the memorandum, the staff recommended against such a reduction--at least so long as the Committee continued to formulate targets for the monetary aggregates for three months or so ahead, and the policy records were to include information on those targets with a reasonable degree of specificity. Under those circumstances, the

^{1/} A copy of this memorandum has been placed in the files of the Committee.

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staff believed that publication of the records with only a 60-day lag could sometimes have undesired effects on financial markets. That was because at the date of publication the target period often would still have a substantial time to run; and from information on the target, market participants might draw inferences about likely System operations over the remaining part of the period.

Mr. Mayo asked whether there was any substantial outside pressure for earlier publication of the policy records.

Mr. Brimmer said he had asked the staff to look into the matter primarily because the Committee had agreed--when it had first adopted the 90-day lag in 1967, following enactment of the Public Information Act--that it would consider the possibility of a shorter lag after some experience had been gained. There had been comments from time to time, in the financial press and elsewhere, suggesting that a 90-day lag was unnecessarily long. However, on the basis of the staff's analysis, he was convinced that it would be unwise to shorten the lag as long as the Committee continued its present procedures with respect to the monetary aggregates.

Mr. Daane remarked that to him the staff memorandum pointed up the need to consider carefully the degree of specificity with which the Committee's targets should be reported in the policy records. That question had been brought into sharp focus recently

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when the Board had reviewed the draft policy records for the meetings of November 17 and December 15, 1970. He believed that the Committee should be as forthcoming as possible, but it should also take account of the risks in going too far in that direction. He thought it would be desirable to pull back somewhat from the current practice, and then perhaps reconsider the possibility of reducing the time lag to 60 days.

The Chairman commented that the course Mr. Daane had suggested seemed worthy of consideration. However, he would hope to avoid an unduly sharp break from recent practice.

Mr. Hayes said he found the staff's arguments convincing and would favor accepting their recommendation.

Mr. Morris said he did not find the memorandum convincing; it seemed to him that the staff was underestimating the market's ability to adjust. Market participants certainly were aware that the Committee changed its policy from time to time, and they were not likely to be misled by information about a two-month old policy decision. In his judgment, the more information the Committee gave the market the better both the market and the Committee would function.

Chairman Burns remarked that the logical conclusion of such an argument was that the Committee should publish its directives as soon as they were adopted--a course he thought few members would favor.

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The Chairman then asked Mr. Cardon whether he was aware of any sentiment in the Congress for shortening the time lag in the publication of the Committee's policy records.

Mr. Cardon replied that he knew of no specific sentiment of that sort. However, there was a continuing interest in the Congress in obtaining more information from the Federal Reserve, and he was unable to say whether or when that general interest might focus on the policy records.

Chairman Burns expressed the view that the Federal Reserve regularly supplied more information on its operations to the legislative branch and the public than any other major central bank.

The Chairman then asked whether there would be any objections at this time to continuing to publish the FOMC policy records with a 90-day lag. No objections were heard.

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

Thereupon the meeting adjourned.


Secretary

ATTACHMENT A

February 8, 1971

Drafts of Current Economic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on February 9, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services, which declined in the fourth quarter of 1970, is rebounding in the current quarter with the resumption of higher automobile production. The unemployment rate remained high in January. Wage rates in most sectors are continuing to rise at a rapid pace, and recent increases in some major price measures have been relatively large. Interest rates have fallen considerably further on balance in recent weeks despite continued heavy demands for funds in capital markets. Federal Reserve discount rates were reduced by an additional one-quarter of a percentage point to 5 per cent. Bank credit increased considerably further in January, as business loan demands strengthened somewhat and banks made substantial further additions to their holdings of securities. The money stock narrowly defined grew modestly in January following a stronger December rise, but money more broadly defined expanded sharply further as a result of continued rapid growth in consumer-type time and savings deposits. The over-all balance of payments deficit in the fourth quarter was about as large as in the third quarter on the liquidity basis; on the official settlements basis the deficit increased further from the very high third-quarter level 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 the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation 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 accommodative conditions in credit markets; greater growth in the narrowly defined money stock, making up the shortfall from the desired growth path that has developed; and continued rapid expansion in other monetary and credit aggregates. 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 accommodative conditions in credit markets, greater growth in the narrowly defined money stock, and continued rapid expansion in other monetary and credit aggregates. 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, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining prevailing money market conditions, provided that monetary and credit aggregates appear to be expanding at least as fast as projected.