MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 21, 1971, at 9:30 a.m. As indicated below, only a limited number of staff members were in attendance during the first part of the meeting.

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

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

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

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Hersey, and Solomon, Associate Economists

Messrs. Bryant and Gemmill, Associate Advisers, Division of International Finance, Board of Governors

Messrs. Bodner and Sternlight, Vice Presidents,
Federal Reserve Bank of New York

Chairman Burns said he was pleased to welcome Mr. Willis J. Winn, who was attending his first meeting of the Committee in his capacities as Alternate Member and President of the Federal Reserve Bank of Cleveland.[1] The Chairman observed that Mr. Winn needed no introduction to those present, in view of his extended period of service as director and Chairman of the Philadelphia Reserve Bank and of the many ways in which he had been of help to the System over the years.

Chairman Burns then remarked that, as the members knew, Messrs. Daane, Solomon, and he had participated in last week's London conference of the Ministers and Governors of the Group of Ten. Developments at such a conference obviously were of a sensitive and delicate character. To facilitate a frank discussion, he had asked that staff attendance at the first part of today's meeting be limited to those persons whose presence was most urgently required.

The Chairman then invited Mr. Daane to give his impressions of the London conference. Mr. Daane made the following remarks:

> I thought it would be useful, before plunging into a report on the London meeting, to comment on two earlier meetings: the Paris meeting of the Deputies of the Group of Ten held on September 3-4, and the Basle meeting of central bank governors held on September 12. I think these meetings provide a useful perspective on, and in

1/ Mr. Winn had taken his oath of office as an Alternate Member prior to today's meeting.

many ways foreshadowed, the London meeting. And, of course, as you know, the summary by Rinaldo Ossola, the chairman of the Group of Ten Deputies, was the first item on, and the point of departure for, the agenda and discussions at the London meeting.

Turning first to the Deputies' meeting on September 3-4, the agenda consisted of two items--namely, discussion of world payments disequilibrium and what to do about it. With respect to world payments disequilibrium, the consensus of Deputies was that we were faced with a situation of fundamental disequilibrium and, while it showed mainly in the United States, other countries were also affected in varying degree. In connection with the discussion of the extent of disequilibrium, Under Secretary Volcker had exposed the U.S. position with respect to the magnitude of the problem, pointing to a required swing of $13 billion. The reactions of the Deputies were, first, that the $13 billion figure was too pessimistic and that the political implications of such an adjustment might be too formidable and its economic implications unacceptable. They also felt that the use of projections made the target figure too hypothetical. Furthermore, they questioned why the United States had an objective of a surplus rather than equilibrium. In addition, fears were expressed at the Deputies' meeting about removal by the United States of its present restrictions on capital outflows.

With respect to the second question on the agenda--that of possible remedial actions--the Deputies began by recognizing that more than rate alignments was involved. As to rate alignments, there was general agreement that a selective realignment of exchange rates was necessary and desirable; and a general consensus, excluding the United States, that the currency realignments required "contributions" from deficit as well as surplus countries. The Deputies also, of course, discussed the U.S. import surcharge. There was nearly unanimous agreement among them that the surcharge was an obstacle to the achievement of an adequate realignment of exchange rates and should be removed as soon as possible. At the conclusion of the meeting there was much discussion of, but little progress on, the question of how we would negotiate our way out of the present situation.

As to the Basle meetings, all of the central bank governors regularly attending such meetings were present on September 12. Mr. Inoue represented Japan, and at the governors' dinner that evening the governors from Spain, Austria, and Denmark were also present. The mood at Basle was one of, if not despair, at least despondence. Generally speaking, it was felt that an impossible situation had been brought about by the U.S. actions. There were really no expectations of any results from the then-forthcoming London meeting; in fact, there was considerable trepidation as to what Secretary Connally might say, bearing in mind what they considered to be a rather bombastic speech at Munich.

But to describe the meeting in a little more orderly way, the first item brought up by President Zijlstra of the BIS was the question of the decisions--taken formally in June to apply for a three-month period--not to invest in Euro-dollars and to consider withdrawals when and as prudent. Some of those present quite clearly were willing and eager to continue these decisions and to take another look at them in November. But several present, most notably the French and British governors, indicated they would no longer make a formal commitment, particularly in the light of the U.S. decision not to roll over the $500 million in special Treasury issues in the Euro-dollar market. The conclusion was reached not to make a commitment but generally to continue the same attitudes toward placement of funds in the Euro-dollar market. There was a strong expression of views that no publicity should be given to the decision to discontinue the commitment.

Mr. Zijlstra then turned to the question of renewal of the second Basle arrangements. Following agreement in principle earlier this year, the British governor had contacted the other sterling area countries and all except four of those countries already had agreed to renewal on the same basis as before. The Basle group was asked to give formal approval to the renewal for a two-year period. Representatives of all parties to the arrangement agreed except those of the United States, who reserved judgment subject to discussion with the U.S. Treasury.

Next, Mr. Zijlstra turned to the major substantive discussion of the afternoon--namely, the question of what kind of monetary system we wanted for the future. He set the tone for this discussion by stressing that we ought not to look back or to engage in recriminations,

but rather to look forward and ask ourselves what we really wanted in the way of a system. He underscored the crucial question of how we could bring about the sort of system we want without reproducing the same problems and dilemmas as had brought the system into its present situation.

Mr. Zijlstra concluded his introductory comments by saying that he was deeply worried about the prospects for the world economy. He went on to comment along these lines: Too many people think we are in an easy world now, where the problems can simply be solved by the market. While it may look that way superficially, this view is terribly mistaken. The world is running two very serious risks: First that trade restrictions will gradually creep into the system; this would not necessarily mean a trade war but rather more likely "creeping protectionism." Step by step, we could very easily "recreate the miseries of the 1930's." Second, with respect to the business cycle, the prospects were already not favorable, with tendencies to recession showing in a number of countries. The uncertainties in the present situation could have an adverse effect on investment and further complicate the tasks of achieving stability and growth.

The responses of the others present, excluding the United States, may be summed up along the following lines:

(1) Quite clearly all those present wanted to return to a relatively fixed rate system with wider margins to add flexibility.

(2) Any new system should be based on a "neutral reserve instrument" rather than be one in which the dollar had special privileges.

(3) A new system clearly requires a process of realignment to which <u>all</u> must make a contribution.

(4) There was general agreement that the conditions of the world economy were potentially as Mr. Zijlstra had described them.

(5) All were agreed that the U.S. surcharge was a major impediment to realignment, a major prod to restrictions elsewhere; and they pressed for early removal.

For my part, I said that I welcomed the spirit of the Chairman's introductory presentation--namely, that we should look forward in terms of the sort of system we wanted to bring about. I underscored the point made by Mr. Zijlstra that we needed to bring about a system

that would not produce the same problems and dilemmas as had brought the system to its present position. On this score of restoring a viable system, I observed that our Treasury had made clear in Paris the magnitude of the problem as best it could be determined on an objective basis. Our basic balance of payments had been deteriorating since 1964, and the deterioration, most notable in the trade balance, had accelerated this year. If we projected the trends as realistically as possible, we foresaw a basic deficit of more than $8 billion this year and close to $9 billion next year. As Mr. Zijlstra had correctly noted, to bring about a modest surplus over-all would necessitate an $8 billion surplus in our trade account which, taking into account projections (allowing for cyclical adjustments) showing a trade account deficit of some $5 billion, would represent a required swing of $13 billion in our position. This was not simply an arithmetical exercise but rather a demonstration of the fact that we faced a substantial problem in restoring a durable system. As far as the figures were concerned, our Treasury felt that the $13 billion requirement was a conservative or "minimal" estimate since it made no allowance for an outflow of long-term capital to developed countries, any other moves on the part of the EEC, and so forth. Nor did it allow sufficiently for the lags in impact of exchange rate adjustments.

As to the reform of the system, which constituted an integral part of the total, I noted that the United States had no blueprint, but quite clearly we had had in clear sight in the IMF the possibility of somewhat wider margins, a mechanism for transitional floats, and other possible ways of making the system less rigid. Finally, I had heard one or two of those present make comments about the need to squeeze down on liquidity. For my part, I expressed the personal judgment that a durable system over time would require considerable additions to world liquidity. Once the system had been restored, quite clearly there could be a major influx of capital to the United States. But even more important, the durability of the system in the longer run would necessitate sizable additions to liquidity--particularly if we were to deemphasize both the role of gold in the system and the contribution of dollars to world liquidity.

Responding to a comment by the French governor to the effect that the "missing chapter" was what the

United States proposed to do in the monetary and fiscal policy areas, I then turned to the question of the U.S. domestic economy and our current policy mix. I elaborated on the status of the wage-price freeze, the President's fiscal program, and the present course of monetary policy including the slowing down of the monetary aggregates.

At the dinner meeting that evening the discussion continued along much the same lines. Nothing new was added except that it was quite clear that the Benelux countries had a predilection for moving to a system of regional blocs with floating between blocs but rates maintained within a bloc. Mr. Zijlstra had invited any others to join in such a bloc and the Swedish governor and at least one other indicated they would be glad to do so.

The London meeting of Ministers and Governors of the Group of Ten was held at Lancaster House on September 15 and 16, beginning in the afternoon of the 15th. The meeting was, not unexpectedly, inconclusive in terms of results. As Mr. Solomon pointed out to the Board yesterday, the press reports of a deadlock are probably unfair in implying that a result was expected to emerge, while in fact there was no such general expectation among officials attending. There was some forward progress at the meeting, at least in exposing positions and gaining somewhat greater understanding of the various views. Perhaps Mr. Zijlstra put it best when he said the meeting had translated "what was really an impossible problem into an extremely difficult one." There was general agreement on the need for realignment of currencies and a general recognition that any future system should include greater flexibility.

But again, to report the meeting in a little more orderly way, the first item on the agenda was the report by the Chairman of the G-10 Deputies on the Deputies' meeting which I have already summarized. Following Mr. Ossola's summary, Mr. Ferrari-Aggradi, the Italian Finance Minister, set the stage for the views generally expressed by the EEC countries. As to the magnitude of the adjustment problem, he questioned whether the U.S. target should not be balance, or even a small deficit in the short term, rather than a surplus; he questioned the speed and timing of the adjustment; and he called for a change in the gold price by the United States that would leave the weighted average price of gold unchanged. As to realignments, he suggested that the market rates were distorted by the

surcharge and implied that alignments could be negotiated only after the surcharge had been removed. He clearly called for a system based on fixed parities but with wider margins to contain capital movements, with the dollar reduced to an intervention currency role, and with parities defined in terms of SDR's. And he stressed the great importance of restoring the Fund's operations, and the urgency of the problem. In conclusion, he said he was conscious that this meeting was "the first step in a long and difficult negotiation but to waste time is unforgivable." There was a chorus from the rest of the EEC Ministers on the need to remove the surcharge and for the United States to make a contribution to realignment. A number of Ministers noted the need for reforming the international monetary system, including a phasing out of the reserve role of the dollar; and many if not most talked about the need for greater flexibility. As for the U.S. position, it was laid out in considerable detail by Secretary Connally. He stressed the absolute necessity of returning to equilibrium with some margin of safety, and he referred to the $13 billion swing as a necessity. He spoke of the irony of talking about establishing or maintaining capital controls at a time when we were talking about reestablishing an international system and international monetary stability. He made clear that he would not time the lifting of the surcharge but made it contingent on actions of others. He stressed the necessity of including burden-sharing and elimination of restrictive trade barriers. He stated categorically that everyone there was very familiar with his Government's position with respect to the price of gold. In conclusion, he noted that both as to the problem and remedies "this is a matter that has to be decided by the nations here represented and I think we need first to establish these two things: (1) The magnitude of the problem, which we think is very clearly established, and (2) at least the acknowledged willingness on the part of nations to assume their share of the burden."

Central to the discussion also was a statement by the Managing Director of the International Monetary Fund, Mr. Schweitzer, who listed the main issues, separating them out in terms of possible stages. The Managing Director had made a strong plea for beginning to negotiate the issues in the first stage, and at the concluding session of the Ministers on Thursday much attention was given to the possibility of adopting

this as a work program. Mr. Schweitzer's list of issues was as follows:

(i) A realignment of currencies.

(ii) A decision on the price of currencies in terms of gold and, what is perhaps more important, in terms of SDR's and positions in the Fund.

(iii) The adoption of somewhat wider margins, at least on a temporary basis in present uncertainties.

(iv) The abolition of the U.S. surcharge.

(v) Measures designed to improve the U.S. balance of payments that lie outside the exchange rate field.

(vi) New understandings about the role and the convertibility of the U.S. dollar and, for the longer term, on the place of reserve currencies, gold, and SDR's in the international monetary system.

(vii) The desirable way of handling flows of capital between industrial countries, including controls, monetary policy, etc.

Mr. Schweitzer had included the first four in his immediate work program. This was, however, rejected by Secretary Connally on the grounds that we should have some time to have our Deputies take a hard look at this program; and, more particularly, because it seemed to demote the trade and burden-sharing issues to a subsequent phase and to put the gold price in the forefront of the issues.

As to where we go from here, at best it is an extremely difficult problem to determine how to phase together the various aspects, particularly realignments along with progress in the removal of trade restrictions and burden-sharing--while, of course, taking the first steps and exploring further steps toward the reform of the international monetary system. No one seemed to have a really satisfactory formula as to how to move forward on all of these fronts at the same time. As to procedure, it was agreed to have a meeting of the G-10 Deputies in Washington on Saturday, September 25, to prepare a work program for consideration by the Ministers and Governors of the Ten at their meeting on Sunday. The only concrete part of the work program which had general agreement was a call upon Working Party 3 to continue its deliberations on the magnitude of the adjustment problem.

In response to the Chairman's request for comment, Mr. Solomon said he had only a few observations to make. There had been a great

deal of discussion recently about the risks that the U.S. import surcharge might lead to retaliatory actions by other countries and that it might contribute to recessionary tendencies abroad. He thought it was worth noting that problems would be posed for other countries by any development affecting their external positions--including a realignment of exchange rates. The effects of a realignment of rates would not be identical to those of the surcharge, and there seemed to be general agreement that a realignment was necessary and desirable. Nevertheless, to some extent a realignment might result in reactions similar to those the surcharge had produced.

Mr. Solomon added that a successful rate realignment--i.e., one that had the intended effect on the U.S. balance of trade--would necessarily involve internal adjustments in the surplus countries that were heavily dependent on exports. For example, Japanese adaptation to a significantly smaller export surplus would require them to institute domestic policies directed at absorbing the resources released by export industries.

On the subject of greater exchange rate flexibility, Mr. Solomon continued, there had been general agreement at London that wider margins were desirable, as Mr. Daane had noted. However, there had been a certain element of vagueness in comments on that question. For example, when the Italian representative set forth the position of the EEC countries, his choice of words

seemed to reflect an effort to strike a compromise between the positions of Germany and Italy on the one hand and France on the other, with the latter less inclined toward flexibility than the former. In his (Mr. Solomon's) judgment, the outcome on that issue was still somewhat uncertain.

Chairman Burns then remarked that he had received a number of communications in response to his request at the preceding meeting for any observations Committee members might care to make regarding the future course of the international monetary system. He had found those communications to be quite helpful, and he would be grateful for any further observations the members might make today or might put in writing after the meeting. He asked whether there were any comments or questions at this point.

Mr. Swan referred to Mr. Daane's comment regarding Mr. Zijlstra's invitation to other countries to join the Benelux currency bloc, in which exchange rates were fixed internally but floated against other currencies. He asked whether such blocs were likely to become a significant factor.

Mr. Daane replied that currency blocs of that type might become significant in the future. At the moment, however, the Benelux countries had been able to interest only one or two other countries, not including any of the larger EEC nations, in joining their bloc.

Mr. Hayes said he would like to underscore the difficulties he thought were likely to be encountered in finding solutions to two key problems. The first, on which Mr. Daane had touched, related to the timing of negotiations on various individual issues. Thus, it was the U.S. view that the import surcharge should not be removed until a satisfactory agreement had been reached in connection with burden-sharing. However, other countries considered the surcharge to be a strong deterrent to a realignment of exchange rates, since both had serious implications for their foreign trade positions. A considerable amount of time was likely to be required to resolve that difference. Secondly, he thought there would be great difficulty in reaching agreement on the matter of U.S. restrictions on capital outflows to Europe. Revaluations sufficiently large to produce equilibrium in the over-all U.S. balance of payments, with complete freedom of capital movements, were likely to be strongly resisted by other countries; undoubtedly, they would be highly reluctant to accept the sizable trade deficits that would be necessary to facilitate unrestricted capital outflows from the United States.

Mr. Mayo asked about the position taken by the Japanese representatives in the recent international meetings.

Mr. Daane replied that most of Mr. Inoue's comments at Basle had been concerned with the Bank of Japan's recent foreign exchange operations. Mr. Inoue reported that the Japanese had

considered it necessary to limit the appreciation of the yen because of the highly uncertain outlook for their domestic economy, and that during the float period the Bank of Japan had acquired a substantial amount of dollars in market intervention operations, in addition to tightening exchange controls. At the London meeting the Japanese representative had expressed the view that there was no fundamental disequilibrium in Japan's external position.

Mr. Solomon added that, despite the emphasis the Japanese had placed on their view that they were not in fundamental disequilibrium, they had expressed a willingness at London to participate in concerted action to realign exchange rates.

Mr. Mitchell asked whether some of the issues now under negotiation might not best be dealt with in bilateral discussions rather than in more general meetings.

Chairman Burns expressed the view that bilateral discussions or meetings of small groups of nations might prove quite helpful in facilitating progress on a number of key issues. Indeed, much could be said for approaching the whole complex of issues in that way, if time permitted such an approach.

The Chairman went on to say that the current international problem was not simply an economic one, involving realignments of exchange rates and readjustments of trade relationships; there also were important political implications. It was not yet wholly clear how the latter would affect the outcome, since various crosscurrents

were at work. For example, the British and other countries looking toward entry into the Common Market were tending to align themselves more with the European viewpoint and less with that of the United States; the Japanese appeared to be uncertain as to whether to look more to Europe or to the United States; and the Europeans appeared to be uncertain with respect to their attitudes toward Japan.

Mr. MacLaury remarked that as long as a system of fixed exchange rates had been in effect a good case against floating rates could have been made on the grounds that it was risky to move into an unknown area. However, now that most major currencies were on a floating basis the case for moving back to fixed rates seemed to him to be considerably weaker. Moreover, as Mr. Solomon had noted, the realignments needed to bring about a large shift in the U.S. trade position would involve difficult adjustments on the part of other countries. He thought it would not be possible to reach agreement quickly on the size of the necessary parity changes, and that there would be risks in any effort to do so.

For such reasons, Mr. MacLaury continued, he believed that the present objective should be to reach agreement on a set of rules for operating under a system of flexible exchange rates, at least for some interim period. He personally would favor removing the import surcharge and eliminating the discrimination against foreign capital goods in the proposed investment tax credit if,

as he believed likely, such steps would facilitate an agreement on operating rules for a flexible exchange rate system.

Mr. Morris said he was inclined to share Mr. MacLaury's views. In that connection, he would be interested in hearing from Mr. Bodner how well the exchange markets seemed to be adapting to floating rates in the areas in which exchange controls were not seriously impeding transactions.

Mr. Bodner replied that the exchange markets were beginning to adapt to the new situation, but their recovery thus far had been very slow. Spot markets were able to cope with the needs for current commercial payments, but they were thin and erratic and the cost of doing business in them had risen. The over-all volume of trading was only a fraction of its previous level; there were virtually no capital flows, and the usual type of arbitrage business had dried up. Forward markets had largely disappeared, except for transactions in sterling, and to some extent, in German marks. In general, the major trading banks were acting with extreme caution, trying to minimize their risks by minimizing their positions. In many currencies it was virtually impossible to enter into a forward contract, and that fact was beginning to interfere with trade.

Mr. Bodner added that the longer the present situation persisted the better the markets would adapt to it. However, he would expect the process to remain a slow one. In particular,

banks were likely to remain hesitant about entering into forward contracts.

In response to questions by Mr. Brimmer, Mr. Bodner agreed that to a large extent the reduced volume of capital movements was a consequence of controls, and that it was difficult to separate out the impact of floating exchange rates. He also agreed that there were no particular problems in dealing in the Canadian dollar. He noted, however, that that currency had been floating for an extended period so that the market had had ample opportunity to adapt.

Mr. MacLaury observed that a good deal of the current uncertainty in the foreign exchange market no doubt was attributable to the fact that international monetary negotiations were now in progress. That, of course, was not necessarily the whole explanation.

Chairman Burns expressed the view that the experiment with floating exchange rates now under way was unlikely to prove successful. Over the years academic economists had argued that the only true test of the value of a currency was in the market place, and that it was undesirable to fix exchange rates arbitrarily. Such arguments seemed highly reasonable until one realized that they involved the tacit assumption that there were no governments and no political pressures in the world. In the real world--with active governments subject to strong pressures--it was highly unlikely

that free play would be given to market forces. Instead, restraints were apt to multiply; governments were likely to take such actions as subsidizing exports to protect their foreign trade positions; and dual exchange rate systems were likely to spread--all of which would tend to frustrate hopes for an improved international monetary system. With respect to forward markets, it was a fact that much international trade was in heavy capital goods sold on small profit margins. Under floating exchange rates, trade in such goods probably would depend to an important extent on the existence of foreign exchange markets in which traders could arrange forward contracts with relatively long maturities; and in his judgment the prospects for the development of such markets were not bright.

Mr. Francis noted that the Chairman had described the current period of floating rates as an experiment. He asked whether it was not true that the chances of success of such an experiment were impaired by the existence of the U.S. import surcharge.

Chairman Burns said he would be inclined to agree with Mr. Francis if the focus was on economic considerations alone. On balance, however, he thought it would be undesirable for the United States to remove the surcharge at this point unless there was some indication that satisfactory agreements would be reached on other key issues.

Mr. Daane remarked that it was quite easy to exaggerate the importance of the surcharge as an impediment to a true market test of the relative values of currencies, in light of the fact that other countries had made it quite clear that they were not prepared to let their currencies float upward freely in response to market forces.

Mr. Heflin said it was his impression from developments in the Fifth District that the longer the surcharge remained in effect the more difficult it would be to remove.

Mr. Kimbrel observed in that connection that the present situation might become frozen unless some resolution of the issues under negotiation was reached soon. He asked whether there was any date by which it was hoped that agreement could be reached.

Chairman Burns replied that he knew of no way of specifying such a date. He then remarked that he had found today's discussion to be highly useful. As he had indicated earlier, he hoped that the members would put in writing any further thoughts they might have regarding possible means of making headway in the current situation.

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign

currencies for the period August 24 through September 15, 1971, and a supplemental report covering the period September 16 through 20, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Bodner said that, as was clear from the discussion this morning, the pattern of responses that began to emerge immediately following President Nixon's August 15 speech had been further elaborated over the past month, with a hardening of negotiating and defensive positions on both sides. Restrictions on the movement of capital had been proliferating as most major countries attempted to prevent inward capital flows or, at the very least, to isolate them from current transactions. That effort had been motivated partly by a desire to protect negotiating positions--by preventing the exchange rate from rising to a level that would prejudge any future parity adjustments--and partly to defend against a real deterioration in the current account. Most European countries were, in fact, running trade deficits with the United States and had only modest surpluses, if any, on over-all current account. Consequently, it was not surprising that the measures taken to date had been designed to make it clear that they were not prepared to accept readily a significant weakening of their current account positions. They feared that such a weakening could bring

domestic unemployment and perhaps a significant economic downturn.

It had been evident in the discussions at Basle that the fear of recession was widespread, Mr. Bodner continued. The rapid secular growth of world trade had been a major stimulus to economic expansion in Europe and Japan, and there was very great concern over the threat that a proliferation of controls--or worse, the development of a trade war--could lead to a world-wide recession. In that environment there was strong impetus for agreement, at least within Europe, on a common position that could protect them from serious disruption of their general trade relations, regardless of what happened to their relationship with the United States. Thus, the possibility of the formation of a European monetary bloc was very real. To his mind, the fact that the Swedes had shown an interest in joining such a bloc was highly significant, since in past international discussions they had tended to align themselves with the United States. Exactly how the Canadians and Japanese would fit into such a structure remained to be seen, but clearly both countries shared many of the same concerns, and they also had taken defensive measures.

Mr. Bodner remarked that the exchange markets had been attempting to function in the face of the massive uncertainties resulting from the U.S. initiatives and a continuing barrage of

official and semi-official reactions and proposals. It seemed clear that most dealers did not yet appreciate the full extent to which the monetary system had been shaken. In particular, he thought many people had not yet absorbed the fact that the reestablishment of exchange trading on the basis of relatively fixed parities ultimately depended on far more than just reaching agreement on the extent of revaluation for various currencies--difficult as that would be. The critical question was that of dollar convertibility--or to put it more generally, of having acceptable reserve assets. That, of course, was a prerequisite to the reestablishment of some sort of par value system.

Mr. Bodner noted that some of the difficulties in the present situation were illustrated by the recent operating experience under the Benelux monetary bloc. As a result of the agreement to maintain the rates of exchange for their currencies within 1-1/2 per cent of the ratio of previous par values, the Dutch had been acquiring Belgian francs on a rather substantial scale. Thus far, they had not been able to arrive at any mutually satisfactory method of settling the franc balances. The Dutch did not want to acquire more dollars and the Belgians were reluctant to sell gold at the present price; and since the IMF had indicated that transactions in SDR's would have to be at present dollar prices, neither wished

to use SDR's for settlement. For the time being, the Dutch were simply accumulating francs.

As he had indicated earlier, Mr. Bodner continued, bank managements generally had been instructing their exchange dealers to minimize their exposure at all times, even at the cost of refusing to undertake contracts for regular customers if the traders could not find appropriate offset. Most banks were not merely permitting, but were actually encouraging, the runoff of their forward positions as contracts matured.

Although it was still rather early in the game, Mr. Bodner remarked, the disruption of the markets--and in particular, the extreme difficulty of obtaining forward cover in the face of current uncertainties--apparently was already beginning to have its effects on trade. Reports were being heard increasingly of commercial firms having abandoned attempts to conclude contracts for future trade because of their inability to fix costs and prices in the present environment. The proliferation of exchange controls had added to the burden, for it was always extremely difficult for banks outside any country to be thoroughly familiar with that country's exchange control regulations. For example, there had been a shift of business in the French franc from New York to Paris because New York banks at times had considerable difficulty in learning whether a transaction could be effected in the official

market or had to be put through the financial market. The most extreme example was the case of Japan, where the tightening of exchange control regulations had brought a virtual cessation of trading in yen and a halt in Japanese trade payments.

As far as the spot exchange rates were concerned, Mr. Bodner observed, with the exception of the yen, movements had been relatively modest over most of the period since the last meeting. The mark had remained about 7 to 7-1/2 per cent above its old ceiling, the guilder 4-1/2 to 5 per cent, and the Belgian franc 3-1/2 per cent. Sterling had moved up to 2 per cent above its ceiling. The fact that those rates had moved no further reflected not only the basic trading positions of the currencies but also the effects of exchange controls, the impact of the U.S. surcharge on market psychology and on actual trade relations, the strong technical position of the dollar which had been so heavily oversold prior to August 15, and--in some cases--some modest central bank intervention. In the past two days there had been a further rise in rates following reports that the United States was insisting on a revaluation of the mark in the 12 to 15 per cent range. However, rates in general eased after the German authorities began selling marks forward for one, two, and three months in an effort to resist the upward pressure on the spot rate.

The major exchange market development in the period was the partial floating of the Japanese yen, Mr. Bodner noted. The initial

reaction of the Japanese to the President's address had been to tighten exchange controls sharply. Because virtually all Japanese trade was denominated in foreign currencies--mainly dollars--the Japanese authorities had felt that they had no alternative but to keep the exchange market open within the previous ceiling. Their attempt to keep themselves from being flooded with dollars, however, had resulted in the complete disruption of their payments mechanism, so that they were forced to relax the regulations. As soon as they did so, however, they were flooded with $1.7 billion in two days, August 26 and 27. Under that pressure they decided to let the yen float upward to some extent. In order to limit the rise in the rate and, at the same time, to minimize the amount of dollars they would have to acquire in doing so, they once again tightened their exchange controls. As a result of that juggling act, the yen had moved up about 5-1/2 to 6 per cent above its old ceiling and the Japanese had taken in about $1 billion additional. Meanwhile, the problems of executing payments to Japan continued to plague the market.

While the exchange markets had been seesawing in nervous and erratic trading, Mr. Bodner continued, the gold markets had tended to settle down. After an initial surge above $43, the price in London quickly receded to around $41.50. It had remained

at about that level until the last few days when it moved above $42 again. The absence of strong speculative demand for gold was generally being attributed to the high cost of financing positions and to the reiteration by the United States of its opposition to any change in the official price. Moreover, even among those who expected a change, there appeared to be a belief that it would fall in the 10 per cent range. That was not interesting to private speculators, since the free market price was already well above that level.

While on the subject of gold, Mr. Bodner said, he might mention the discussion of the current status of the two-tier system that had occurred at the recent meeting in Basle of the group of foreign exchange market experts. It was the position of the U.S. Treasury that the change in U.S. policy with respect to gold convertibility did not affect the 1968 Washington agreement under which the two-tier system had been established, and that the parties to that agreement were still bound by their commitment to stay out of the private market. However, it was the consensus of the experts from other countries that the Washington agreement was no longer binding, since it had been premised on the continued willingness of the United States to buy and sell gold at $35 an ounce. At the same time, the experts thought it would be in the best interests of all parties to act as if the agreement were still in effect.

Mr. Daane observed that that subject had not been raised in any of the governors' sessions at Basle.

Mr. Bodner said he was not surprised, in light of the fact that the experts at Basle had talked as if their conclusions were so obvious as to require little or no discussion.

Mr. Brimmer noted that in the course of some recent briefings by Board staff members he had received the impression that foreign central banks were no longer keeping the U.S. authorities as fully informed about their foreign exchange operations and positions as they had prior to the President's address. He asked about the recent experience of the New York Bank in that regard.

Mr. Bodner replied that there had been a significant change in the willingness of certain central banks to supply information on their daily operations. For example, it had been the earlier practice of the Bank of Italy to inform the New York Bank each week regarding its daily operations for the preceding week, and to transmit immediate advice if it had engaged in an unusually large volume of transactions on a particular day. Recently, however, the Bank of Italy had suspended such reports and had indicated that it was not prepared to give information on its market intervention operations. The flow of information from the Banks of England and Japan was no longer very good, at least at the staff level; at higher levels the exchange of information

was still relatively free. There had been no change in the data supplied by the Banks of France and Germany or by the BIS.

Mr. Heflin asked how Mr. Bodner would assess the possibility of repayment by the Treasury before the end of the year of the obligations held by foreign central banks, including those denominated in foreign currencies.

Mr. Bodner replied that repayment of those securities probably would have to await a return flow of dollars to the United States. Of course, the tremendous overhang of dollar holdings made for potentially large return flows, but he would not expect such flows to develop until the present situation was resolved. Accordingly, he thought there was little likelihood of repayment soon.

Mr. Bodner added that, as the Committee knew, the Treasury had permitted half of the $3 billion of special securities that were sold to foreign branches of U.S. banks to run off. Presumably if Euro-dollar interest rates remained high the Treasury also would permit the remainder to run off when they reached maturity.

In response to a question by the Chairman, Mr. Bodner said that foreign currency operations for System Account since the August 24 meeting of the Committee had been limited to the renewal of certain swap drawings on the National Bank of Belgium.

By unanimous vote, the System open market transactions in foreign currencies during the period August 24 through September 20, 1971, were approved, ratified, and confirmed.

Mr. Bodner noted that at the August meeting the Committee had concluded that it would be desirable to renew a $35 million System drawing on the Belgian Bank that matured on September 10, 1971, if agreeable to the Belgians. When the New York Bank suggested that the drawing be renewed for the customary period of three months the Belgians had originally proposed that it be repaid; subsequently, however, they had agreed to a renewal for about one month--to October 12--pending further discussions. When those discussions had been held at the time of the Basle meeting both parties had concurred in the view that under present circumstances it would be desirable to roll over maturing swap drawings for the customary three-month periods. In addition to the $35 million drawing in question, five others totaling $120 million would mature--some for the second or third time--in the period through October 28, 1971. He recommended renewal of all six drawings for further periods of three months.

By unanimous vote, renewal of the six System drawings on the National Bank of Belgium maturing in the period October 7-28, 1971, was authorized.

Chairman Burns then observed that memoranda from the System Account Manager and the Committee's General Counsel on the subject of System lending of Government securities, dated

September 15, 1971, had been distributed to the Committee on September 16.[1] He asked Mr. Sternlight to comment.

Mr. Sternlight noted that it was the Committee's practice to make a semi-annual review of the authorization to lend securities from the System Account because, in the opinion of Counsel, the legality of such operations depended on a factual determination by the Committee that they were reasonably necessary to the effective conduct of open market operations. He had little to add to the Manager's memorandum, which expressed the judgment that experience since the last review indicated that the lending operations were still reasonably necessary to the effective functioning of the Government securities market and hence to the effective conduct of open market operations.

It was agreed that the authorization for the lending of Government securities from the System Open Market Account, contained in paragraph 3 of the continuing authority directive with respect to open market operations, should be retained at this time.

The Chairman noted that a memorandum from Mr. Maisel entitled "Revisions of FOMC Guide for Emergency Operations and

1/ Copies of these memoranda have been placed in the Committee's files.

Emergency Resolutions," had been distributed to the Committee on September 14, 1971.[1/] He invited Mr. Maisel to comment.

Mr. Maisel said that he was proposing certain revisions in the instruments in question primarily for the purpose of deleting references to "due bills." As indicated in his memorandum, such action would be in conformity with a recent conclusion of the Conference of First Vice Presidents of the Reserve Banks that due bills no longer represented the best device for use in an emergency. The Board of Governors had recently made corresponding revisions in its Emergency Regulation No. 1.

By unanimous vote, the Committee's "Guide for Emergency Operations," initially approved on May 29, 1962, was amended in the manner recommended in Mr. Maisel's memorandum of September 14, 1971, primarily for the purpose of removing references to "due bills."

By unanimous vote, the resolution authorizing certain actions by the Federal Reserve Banks during an emergency, which had last been revised on July 21, 1970, was amended to read as follows:

RESOLUTION OF FEDERAL OPEN MARKET COMMITTEE AUTHORIZING CERTAIN ACTIONS BY FEDERAL RESERVE BANKS DURING AN EMERGENCY

The Federal Open Market Committee hereby authorizes each Federal Reserve Bank to take any or all of the actions set forth below during war or defense emergency when such Federal Reserve Bank finds itself unable after

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

reasonable efforts to be in communication with the Federal Open Market Committee (or with the Interim Committee acting in lieu of the Federal Open Market Committee) or when the Federal Open Market Committee (or such Interim Committee) is unable to function.

(1) Whenever it deems it necessary in the light of economic conditions and the general credit situation then prevailing (after taking into account the possibility of providing necessary credit through advances secured by direct obligations of the United States under the last paragraph of section 13 of the Federal Reserve Act), such Federal Reserve Bank may purchase and sell obligations of the United States for its own account, either outright or under repurchase agreement, from and to banks, dealers or other holders of such obligations.

(2) Such Federal Reserve Bank may in its discretion purchase special certificates of indebtedness directly from the United States in such amounts as may be needed to cover overdrafts in the general account of the Treasurer of the United States on the books of such Bank or for the temporary accommodation of the Treasury, but such Bank shall take all steps practicable at the time to insure as far as possible that the amount of obligations acquired directly from the United States and held by it, together with the amount of such obligations so acquired and held by all other Federal Reserve Banks, does not exceed $5 billion at any one time.

(3) Such Federal Reserve Bank may engage in operations of the types specified in the Committee's authorization for System foreign currency operations when requested to do so by an authorized official of the U.S. Treasury Department; provided, however, that such Bank shall take all steps practicable at the time to insure as far as possible that, in light of the information available on other System foreign currency operations, its own operations do not result in the aggregate in breaching any of the several dollar limits specified in the authorization.

The following persons then entered the meeting:

Mr. Bernard, Assistant Secretary
Messrs. Eisenmenger, Gramley, Scheld, and Tow, Associate Economists

Mr. Altmann, Assistant Secretary, Office of the Secretary, 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. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Messrs. Parthemos, Andersen, and Craven, Senior Vice Presidents, Federal Reserve Banks of Richmond, St. Louis, and San Francisco, respectively
Messrs. Willes, Hocter, Brandt, Nelson, and Green, Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, Atlanta, Minneapolis, and Dallas, respectively
Mr. Schadrack, Adviser, Federal Reserve Bank of New York
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

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

Mr. Partee made the following introductory statement:

A month ago I promised that we would prepare an updated projection of the economy, taking account of

the President's new economic initiatives, for this meeting of the Committee. We have done so and our new projection is spelled out in the green book,[1] although I must admit that there have been times over the past several weeks when we despaired of coming up with a logical set of numbers. The difficulty is that we know hardly any more about the effects of the program than we did when it was announced. Very few statistics have become available for the post-freeze period, and those surveys that have been made of changes in consumer buying attitudes are indeterminate. Further, we know very little about the probable outlines of Phase II of the program--except for a growing awareness of the difficulties of maintaining an effective continuing restraint on wages and prices--and it is not yet clear how well the President's fiscal proposals will fare in Congress.

The staff projection for the next three quarters, therefore, must still be regarded as more tentative than usual. We view the outlook as clearly more favorable than before, but any specific numbers seem to us subject to a fairly wide range of forecasting error. Also, we have had to make various important assumptions about the program in order to carry forward the projection. First, we have assumed that Phase II will represent a reasonably effective program of wage-price restraint, holding increases in employee compensation to around a 5 per cent annual rate, after some initial slippage when upward pressures emerge at the end of the freeze period. Second, we have assumed that Congress will accept the President's proposals for fiscal relief and expenditure control essentially intact. Third, we have assumed that the import surcharge will be continued throughout the forecast period, or that changes in exchange relationships will have similar effects on the domestic economy. And fourth, we have assumed that interest rates will remain about where they are, at least into early 1972, which has implications not only for the cost of capital but also for the distribution of savings flows as between financial intermediaries and the market.

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

In essence then, our projections assume a favorable outcome with respect to the President's program. In this environment, public confidence should improve substantially and the economic recovery is expected to gain real upward momentum. We think that there is a good chance that this will in fact occur, but the Committee should be aware of our optimistic frame of mind. This morning Mr. Wernick will discuss our new projection of GNP and related measures. Following that, Mr. Axilrod will comment on the possible implications for financial markets and monetary policy, with particular reference to the prospects for the remainder of this year.

Mr. Wernick made the following statement regarding the economic outlook:

The most likely prospect resulting from the President's new program, accepting the promise of effective wage and price restraint after the freeze and the other assumptions outlined by Mr. Partee, is a more vigorous rebound in economic activity than seemed likely earlier. Prior to the President's announcement, the staff projection pointed to an economic recovery gradually developing strength over the next three quarters, but with real growth still inadequate to absorb our presently unutilized human and material resources. For the first half of 1972, we had projected a rise in nominal GNP at about a 10 per cent rate--but real growth was expected to remain below 5-1/2 per cent.

But with the new program assumed to be reasonably successful we are now projecting an appreciably larger increase in real GNP in the fourth quarter than before and a further rise to close to 7.5 per cent in the first half of next year. With price increases likely to be less rapid--perhaps at around a 2.5 per cent rate following a post freeze catch-up--the expansion in nominal GNP would be little different from that previously anticipated.

So far in this quarter, there have been few visible impacts of the President's program. Available economic data still relate mainly to the period

prior to August 15 and on the whole have been lackluster. The industrial production index showed little strength in July and August even after adjustments for declines in steel output because of liquidation of excess stocks. Nonfarm payroll employment in August was well below early spring levels and the unemployment rate again has moved above 6 per cent. New orders and output of capital equipment continued sluggish and the latest Commerce-SEC anticipations survey scaled down somewhat the already modest increase in business plans for plant and equipment spending this year. In contrast, the performance of residential construction has continued to exceed our expectations, with housing starts rising to record levels in August. Personal income also showed increased strength and there was some hope in the recent higher levels of auto sales that consumers were beginning to react to the new economic programs.

A major underlying assumption of our projections is that the consumer sector will respond fairly vigorously as price increases abate and income flows improve. The surge in domestic auto sales in late August and the first 10 days of September followed the proposed elimination of the excise tax and the freeze on prices of 1972 models. Purchases of available imported cars not subject to the surcharge have also spurted. Although some of the recent and prospective increase in auto sales may be in anticipation of price rises after the freeze, in effect borrowing from future sales, we nevertheless expect domestic-type auto sales to continue at advanced levels into the first half of next year, partly reflecting a shift in demand from imported to domestic models. Increased consumer confidence regarding prices should also spark a more general expansion in consumer spending, especially as the outlook for employment and earnings improves. Lower personal taxes and a military pay increase early next year will further support a stronger consumption trend, although this would be partially offset by the six-month postponement in the general Federal pay raise.

Inventory-sales ratios, especially in durable goods, have been reduced considerably over recent months, setting the stage for substantial inventory restocking on any significant increase in demands. A moderate rise in inventory investment is expected

by the fourth quarter, reflecting in part a slowing of liquidation in steel stocks. But a substantial gain in real inventory investment probably will not appear until the first half of next year, in lagged response to the projected improvement in final sales.

As the rate of real economic growth accelerates and the outlook for profits improves, business should also begin to take increasing advantage of the investment tax credit. Thus, an appreciable improvement in capital spending in real terms for the first half of next year seems in prospect. Because of the amount of idle capacity, however, the gain that we are projecting still falls well short of the increase in capital spending experienced during previous postwar cyclical recoveries.

Residential construction activity is expected to remain a strongly supportive influence in the economy. We are projecting somewhat larger increases in residential outlays than earlier and recent trends may require some further upward revision. We assume, of course, that mortgage interest rates will not rise appreciably and that inflows of funds to mortgage lending institutions will be sufficiently large--along with the support provided by the Federal housing agencies--to assure ample availability of credit to finance the high starts levels we have projected.

While the fiscal incentives included in the President's new program would seem to provide considerable added stimulus to the private sectors, this will be offset in part by the cutbacks in planned Federal expenditures, including the 5 per cent reduction in employment. The net impact of the shift in the Federal budget is nevertheless likely to be moderately stimulative. And with private consumption projected to strengthen, capital investment to rise faster, inventory rebuilding to be more rapid, and housing to remain expansive, sufficient upward thrust in the economy seems probable to produce relatively fast growth without further substantial fiscal stimulus.

Turning to the implications of the projection for resource use, the anticipated increase in the real growth rate to about 7.5 per cent should mean some 500,000 more jobs added to nonfarm payrolls over the next three quarters than previously anticipated. We would also expect some acceleration in the labor

force growth, however, so that the unemployment rate may decline only gradually. We are projecting an unemployment rate of 5.5 per cent by midyear, compared with the 6 per cent rate indicated earlier.

Unit labor costs are also expected to show a more favorable trend. We have assumed that some deferred wage increases will be allowed during Phase II, and that wage restraints will permit something like a 5 per cent rate of increase in employees' compensation. But an improved output performance should lead to a significant increase in productivity growth, so that the rise in unit labor costs should be moderate. This, in conjunction with a program of price restraint, is likely to keep the increase in the GNP deflator at a tolerable rate next year. However, even if economic activity rises at a substantial pace through the coming quarters, there still would be appreciable amounts of unutilized resources, as reflected by the unemployment and capital utilization rates throughout the projection period.

Mr. Axilrod made the following statement regarding the financial implications of the GNP projection:

In evaluating the financial implications of the GNP projection, one of the critical factors to remember is that nominal GNP is expected to rise no more rapidly--and in the fourth quarter less rapidly--than we had forecast before the new economic program. Thus, even though real GNP growth is now projected to be considerably larger than before between now and mid-1972, it does not necessarily follow that demands for credit and money--which, of course, relate to current dollar flows--will be increased as compared with earlier expectations; nor does it follow that interest rates necessarily will have to be higher, at least over the next few months.

One of the principal factors that will affect credit demands and interest rate pressures over the period ahead will be the need for external financing by nonfinancial businesses. If corporate fixed capital and inventory spending work out over the next three quarters as the staff now foresees them, it is probable that the net external financial requirements of corporations will be lower than previously indicated for

that period--and sharply lower than in 1970 or the first half of 1971. The main reason is that spending, while growing considerably in real terms, is projected to rise very little more than we had expected earlier in current dollar terms. At the same time, however, we do expect a considerable increase in the availability of internal funds. Some cyclical recovery in profits had always been in prospect, but now this will be enhanced by the proposed investment tax credit, which will add substantially to retained business earnings.

Given the increased availability of internal funds in prospect relative to capital spending, one would expect the very recent renewed buildup in the corporate bond calendar to be temporary. A drop in the corporate calendar would encourage long-term market interest rate declines and provide some additional room for direct financing of mortgages and for indirect financing through Federal agency issues.

A further decline in longer-term interest rates should permit financing of existing mortgage commitments without any additional rise in mortgage interest rates, and possibly some decline. But even apart from that effect, a decline in long-term market interest rates between, say, now and year-end would be consistent with the reduction in inflationary expectations resulting from the freeze, assuming an effective Phase II program. Without a decline in long-term market interest rates, the real cost to businesses of borrowing would in effect rise for the simple reason that if businesses expect less inflation, they will want to pay lower interest rates. Of course, as recovery in economic activity and profits accelerates, so will businesses' ability to pay higher interest rates; but that accelerated recovery is still in the mind's eye.

An FOMC policy that complements the Administration's economic program not only may involve interest rates below earlier levels--at least between now and year-end--but also may entail moderate growth in the monetary aggregates. In part a moderate growth in M_1 would help to keep inflationary expectations in abeyance, and on those grounds should, of course, be encouraged. But, in addition, economic conditions may lead to a reduction in the demand for money relative

to GNP as both the new domestic and international economic policies increase confidence and reduce the earlier precautionary demands for cash and liquidity. Taking account of reduced precautionary cash demands, and the probable need to begin exerting some restraining influence next year from monetary policy if and as recovery in GNP accelerates, it would seem that the growth rate in M_1 could be slower than the 7 per cent indicated in the June chart show for the fourth quarter and the first half of 1972.

I would doubt, however, that the growth rate for M_1 should be as low as the 2-1/4 per cent annual rate currently expected for August and September together. So low a rate of growth may be acceptable for a while in view of the rapid earlier run-up of cash balances. But if sustained into the fourth quarter and beyond, it would probably not be consistent with avoidance of significant upward interest rate pressures. Transactions demands for cash are likely to be strong over the period ahead as nominal GNP is projected to rise at about an 8-1/2 per cent annual rate in the fourth quarter and at about a 10 per cent annual rate in the first half of next year.

The interrelationships among monetary aggregates and interest rates are most difficult to foresee, of course, in view of uncertainties about the new economic program and about the longer-run public reaction to it. Over the near-term, given the economic and financial outlook, a reasonable stance for monetary policy would be to place some stress on avoiding upward pressure on interest rates, particularly long-term rates. To do that will probably require moderation of potential upward pressure on short-term rates which might be generated by sizable short-term business and consumer credit demands that could occur about the same time as the Treasury has to begin tapping the bill market for its fall cash needs. Thus, over the weeks ahead, the Federal funds rate may well have to move down somewhat from the 5-1/4 to 5-1/2 per cent range recently attained. The blue book[1/] projections suggest that such a move would not lead to any near-term resurgence of M_1 growth, and would in fact lead to growth rates in monetary aggregates--not only M_1, but also M_2 and bank credit--that may be somewhat low relative to a longer-run moderate growth objective.

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

> The directive language of alternative B[1] would be consistent with this type of policy approach for the period ahead. But in its deliberations the Committee might wish to consider the possibility of associating this language with specifications for the aggregates that permitted them to expand as much on balance as indicated by the still quite modest growth paths for alternative C, as shown in the blue book. In practice, this would mean, among other things, that if undue capital market pressures were to develop, the Manager would have more leeway, because of the higher aggregates, for dropping the Federal funds rate.

Mr. Mayo said he recognized that making GNP projections was more difficult now than usual. While he was prepared to accept the staff projections for the most part, he did have a few reservations about them. In particular, he believed that the projected slowing of the rise in the GNP deflator was more hopeful than realistic. Businessmen, bankers, and others in his District overwhelmingly supported the President's program, but many were nevertheless doubtful that the anti-inflationary program would be as successful as was portrayed in the staff projections. While they were waiting to learn the nature of Phase II, their optimism was tempered by the fact that wage and price controls had not been particularly successful in other countries, as the President himself had noted on earlier occasions.

In his view, Mr. Mayo continued, it was important that the Committee not become overly optimistic about prices and begin to

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

pour funds into the banking system. Moreover, he thought it was realistic to expect that the budget measures enacted by Congress would be more stimulative than those the President had proposed. Accordingly, he was not persuaded by the argument that the prospective growth rates in the monetary aggregates were too slow to sustain a vigorous expansion.

Mr. Heflin asked about the basis for the projected slowing of the deflator. Also, he wondered whether the staff expected the wholesale and consumer price indexes to follow a similar pattern of slowing.

Mr. Partee responded that in assessing the outlook for the deflator the staff had tried to take account of the 90-day freeze--which, incidentally, appeared to be extremely effective; an expected post-freeze surge, as deferred wage and price increases were put into effect; and a Phase II program of wage and price restraint. The post-freeze surge was expected to influence the change in the deflator mainly in the first quarter of 1972. It was assumed that the Phase II program would be reasonably effective, in the sense that the average annual rate of increase in employee compensation per man hour would be held to about 5 per cent, compared with about 7 per cent over the past year.

Given the gains in productivity that should result from the projected expansion in activity, Mr. Partee continued,

relatively low rates of increase after the first quarter of next year were projected for the deflator, and also for the consumer and wholesale price indexes. Consumer prices were expected to rise at about a 2-1/2 per cent annual rate and wholesale prices more slowly. The increases would not be that small if food prices misbehaved. According to the Department of Agriculture, however, the outlook for supplies of farm products and foods was favorable; the corn crop was very large, and prospective supplies of beef and pork were good.

On the whole, Mr. Partee said, he thought the staff's price projections were not unreasonable. It should be kept in mind, however, that those projections reflected optimistic assumptions about the effectiveness of post-freeze wage restraints.

Mr. Heflin then observed that the recent slowing of growth in the monetary aggregates apparently was related to an important extent to large international flows of funds. He wondered, therefore, whether the Committee should pay more attention at this time to the bank credit proxy than to M_1 and M_2. Also, he noted that the estimates of the prospective Federal deficit implied a tremendous amount of Government borrowing. He asked whether the upward pressures on interest rates that might result would have a significant bearing on the degree of stimulation provided by the President's program.

In response to the first question, Mr. Axilrod noted that data from the demand deposit ownership survey indicated a nonseasonal drop in deposits of nonfinancial businesses in August, which was consistent with the view that domestic corporations had transferred large amounts of cash abroad. Those transfers had tended to reduce the rate of growth of money. The staff had assumed that no substantial reflow of those funds would develop before the year-end--an assumption which contributed to the relatively low money growth rate projected for the fourth quarter. However, the very large international flows of funds affected bank credit as well as the money supply. For example, the 30 per cent annual rate of increase in business loans in August apparently reflected a surge in foreign borrowing at U.S. banks. Since international developments tended to distort movements in both the credit proxy and the money supply, they did not seem to offer grounds for increasing the emphasis on the former in policy determination.

With respect to Mr. Heflin's second question, Mr. Axilrod continued, the staff estimated that the new economic program would increase the Federal deficit in fiscal 1972 a little, but not enough to have a significant effect on Treasury borrowing needs.

Chairman Burns remarked that if the staff's GNP projections were correct--and they looked reasonable to him--there would be an increase in Federal revenues, and consequently a reduction in the deficit, over the course of the 1972 calendar year.

Mr. Partee agreed. He added that the staff expected that the budget deficit on a national income accounts basis would still be large in the first half of 1972, which was as far as the current projections extended, but that the impact of the new economic program on revenues would be more substantial in the second half (the first half of the 1973 fiscal year). Mr. Axilrod's point, as he understood it, was that the new program involved very little change in the over-all budget for the 1972 fiscal year.

Mr. Brimmer said it was his impression that, even before the new program, the Federal deficit in prospect for the remainder of calendar 1971 had been large enough to pose a sizable financing problem for the Treasury, and that the magnitude of the problem was increased by the new program. He asked whether the staff had a different view.

Mr. Axilrod replied in the negative. He thought the Treasury would have a substantial financing problem in the fourth quarter of calendar 1971. It appeared that the Treasury's net cash needs in that quarter would be about $8-1/2 billion, much of which probably would be borrowed in the short-term area. If the staff's projections were correct, a resurgence of economic activity in the fourth quarter--including considerable inventory accumulation--would generate substantial business demands for credit from banks and in the commercial paper market. Toward

the end of the year, the combination of those Treasury and business credit demands could exert upward pressure on short-term rates, and that pressure could be transmitted to the long-term market. Over the longer-run, however, as a result of the expected improvement in the financial position of corporations, there should be room to accommodate the expected volume of both mortgages and Federal debt.

Mr. Partee remarked that he would not expect substantial upward pressures on interest rates in the fourth quarter. Greater pressures might develop as the first half of 1972 unfolded as a result of the conjunction of rapid gains in business activity, continued large Federal deficits, and a personal saving rate below that of recent quarters.

Mr. Hayes observed that Mr. Partee's analysis of the economic outlook was quite similar to that of the staff at the New York Bank. He hoped that the expectation of a decline in the Federal deficit over the course of 1972 would prove to be correct. However, he was uneasy about the prospect that Congress, in an effort to provide additional stimulus to the economy, would enact measures involving a larger deficit than contemplated by the President's program. He believed that the economic outlook depended crucially on the state of consumer confidence and that the best way to stimulate the economy would be to restore confidence by checking inflation.

Mr. Hayes said he had concluded from conversations with businessmen that capital spending was not likely to expand much in the near future--despite the incentive that would be provided by the investment tax credit--because of the low rate of capacity utilization and the inflexibility of long-range business planning. Also, the provision in the corporate income tax that permitted the carryover of losses might tend to weaken the effectiveness of the tax credit.

In his judgment, Mr. Hayes continued, Phase II of the new program would have to be backed strongly by the right combination of fiscal and monetary policies if it was going to have a reasonable chance of success. His doubts about the probable stance of fiscal policy served to underscore his view that the System could not afford to move to an unduly stimulative monetary policy.

Chairman Burns referred to Mr. Hayes' comments on the unfavorable prospects for expansion in capital spending, and asked whether such prospects might not offer grounds for some fiscal stimulation.

Mr. Hayes said he still thought the best course would be to restore consumer confidence by checking inflation, in the expectation that the resulting expansion of consumer spending would have a stimulative effect on capital spending at a later point. He did not think one could look to the business investment sector for the initial spark.

Mr. Swan noted that, according to the green book, the inflow of funds to mutual savings banks apparently had remained moderate in early September. However, reports from the San Francisco Reserve Bank's sample of California savings and loan associations indicated that the estimated total inflow was surprisingly large in the first ten days in September--about $120 million, compared with about $190 million for the whole month of August. He had no ready explanation for that development and could not say at this point whether it was significant or simply a temporary phenomenon.

Mr. Eastburn reported that the staff at his Bank had developed GNP projections using the Board's model and making roughly the same assumptions as the Board's staff had. Their results were similar to the projections shown in the green book for the period covered by the latter--through the second quarter of 1972. His staff had then considered a longer period and had explored the consequences of different assumptions about the rate of growth in the money supply. The calculations indicated that more rapid rates of growth in money would be associated with greater reductions in the unemployment rate and larger increases in the deflator. While those results were not surprising, they did direct attention to the longer-run implications of the Committee's policy decision today, and they led him to take a conservative view about the desirable growth rates for the aggregates.

Mr. Coldwell said he hoped the green book projections of the course of the economic recovery were correct. However, there were other possible projections which in his judgment also had some chance of being right, including one of slow growth for the next few months and perhaps into early 1972. The actual outcome would depend in part on the effectiveness and degree of public acceptance of Phase II, and also on whether progress in current international negotiations was made soon enough to avoid the kind of restrictive policies that would tend to throttle foreign trade. If developments in both areas were favorable the Committee could become a little freer in its own policy determination.

Mr. Maisel said he was disturbed by one line of reasoning which he had encountered frequently of late and which might have been implied by Mr. Hayes' remarks today. As he understood this particular argument, it was that growth in the monetary aggregates had to be held to a rate much below normal in order to encourage consumers to spend. Specifically, if the money supply were to grow at a rate of 6 or 7 per cent, which would be consistent with the GNP growth projected by the staff, consumers would be induced to save more than they would otherwise, and consequently the projected increase in GNP would not be achieved. If that reasoning were correct, it was not clear to him how the hoped-for rate of expansion in GNP could be attained; it implied that, contrary to all traditional

views of monetary policy, a restrictive policy--which would curtail investment and State and local spending--was required if consumers were not to over-save. He preferred the orthodox theory that more money and credit led to more spending rather than the reverse.

Mr. Hayes remarked that he had not meant to imply such an argument. His point was simply that a restoration of confidence was crucial if consumers were to be encouraged to spend more freely, and that the state of confidence was closely related to the intensity of inflationary expections. He would like to see the monetary aggregates grow at a reasonable rate, although he found it difficult to decide what specific rates might be reasonable. On balance, he was inclined to favor a rate of roughly 5 per cent for M_1 over an extended period but he would not be disturbed if growth was slower for a few months.

Mr. Morris observed that at a recent round-table conference of directors of the Boston Bank there had been general agreement that an investment tax credit at about the level now being considered by the House Ways and Means Committee would have very little impact on the volume of investment spending. In the directors' judgment, the arrangement the President had proposed--calling for a credit of 10 per cent in the first year and 5 per cent subsequently--could have significantly influenced the timing of planned outlays. They thought, however, that by shifting to a proposal for a flat 7 per cent rate the House Committee had defused the

investment tax credit as an important source of economic stimulus in 1972. For that reason, and in view of the need for labor support for an effective Phase II program, the directors had proposed that the investment credit be scrapped and that, instead, the increase in social security taxes scheduled for the first of next year be postponed. If such a change would increase labor support for the Phase II program, he thought it would be warranted.

Chairman Burns observed that the probable effects of various tax proposals was a difficult and controversial matter and he would not take the time to comment on that subject today. He would say, however, that he thought it was unrealistic to believe that a change of the sort Mr. Morris had mentioned would have any substantial effect on the willingness of labor to support Phase II. From some recent conversations with union leaders he had concluded that, while they had definite views on tax matters, their overriding concern lay in the areas of wages, prices, and profits.

Mr. Brimmer remarked that at a meeting of the Board yesterday with the business directors of the Reserve Banks many of the latter had attached a lower priority to the investment tax credit than he would have anticipated. They had argued--rather persuasively, he thought--that it did not make much difference in the

short run whether the tax credit was level or not; what was needed was stimulation of the demand for output so as to reduce excess capacity.

The Chairman noted that a summary of the discussion at that meeting was being prepared and would be distributed to the Committee members.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period August 24 through September 15, 1971, and a supplemental report covering the period September 16 through 20, 1971. Copies of both reports have been placed in the files of the Committee.

Mr. Sternlight said that in the interest of time he would summarize the statement he had prepared for today's meeting. The full text of his statement read as follows:

> In carrying out open market operations during much of the period since the last meeting, the Account Management has picked its way along a difficult course. The main thrust of operations, in pursuing more moderate growth of the aggregates, was to provide reserves sparingly. At the same time, the Desk sought to furnish reserves in sufficient volume to permit some relaxation in the persistently firm money market conditions that developed in the closing days of August and lasted until nearly the middle of September. As additional evidence accumulated, week by week, that the monetary aggregates--especially M_1--were indeed moderating, somewhat more vigorous and overt efforts were made to encourage less firmness in the money market. Even so, aggressive tactics to create markedly easier conditions were avoided,

lest the market gain the misimpression that the System planned, in the light of the Administration's new program, to embark on a strongly expansionary credit policy.

For about the past week the desired modest loosening of money market conditions has been achieved, with most Federal funds trading a shade under 5-1/2 per cent. Since this has occurred against a background of increasing evidence in the published figures of slower growth in the monetary aggregates, financial market observers have seen the recent money market pattern as a logical accompaniment to the behavior of the aggregates, rather than as a substantial new thrust toward ease.

As the recent period unfolded, an effort has been made to track the course of reserves in relation to various types of reserve targets that might be set up. As noted in the latest blue book, total reserves, and particularly nonborrowed reserves, turned out higher than the path mapped out in connection with the previous blue book. Thus, strict adherence to that earlier path would have produced tighter money market conditions than actually occurred. However, in light of the unfolding weakness in the monetary aggregates, the provision of reserves at above-path levels--which indeed permitted only a modest easing of money market conditions--does not seem inappropriate. On an alternative tracking path technique with which we have been experimenting in New York, nonborrowed reserve levels during the period tracked fairly closely, on average, to path levels based on actual required reserves and deviations from path in aggregates such as M_1.

The credit markets responded to a variety of influences in the recent period, but were especially sensitive to the state of confidence in the efficacy of an anti-inflationary program following the 90-day wage-price freeze. Early in the interval, confidence on that score remained high and bond prices rose, although less exuberantly than in the immediate aftermath of the President's mid-August speech. Following the President's September 9 address to Congress, which the market regarded as less forceful on the question of restraints after the 90-day period, bond prices fell back. This was especially noticeable in the corporate market where underwriters had earlier been more enthusiastic than investors, and where a growing near-term calendar had a depressing effect. In the

final days of the period a better atmosphere emerged again, much of it attributable to the President's remarks at a press conference indicating that the Phase II program would be a strong one. Also exerting a constructive market influence in recent days were the published reports of slower money supply growth, the modest easing in money market conditions, and possibly the System's announcement of plans to purchase Federal agency securities.

While rates on Treasury coupon issues declined over the interval since the last meeting, and thus moved further below the mid-August level, some measures of corporate new-issue rates rose over the interval. However, the corporate rates have remained below their mid-August levels. A breaching of those mid-August levels of corporate rates does not seem likely for the near future, but the possibility cannot be entirely dismissed, particularly if the market should lose confidence in the efficacy of a Phase II program, or if the new-issue calendar should build up sharply--perhaps in fear of some sort of capital issues control. System pursuit of relatively unchanged money market conditions might tend to keep corporate rates from coming down, but pursuit of easier money market conditions would not necessarily produce lower corporate rates unless that easing occurred in the context of a sustained slowdown in the growth of money and credit aggregates.

Treasury bills have been something of a special case in the past several weeks because rates at the time of the last meeting and for a week or so thereafter were particularly depressed by the strength of foreign central bank purchases of bills. Once that buying dried up, the pull of day-to-day financing costs and market fears of a possible return flow of bills from foreign hands exerted upward pressure on rates. In the last few days, bills benefited along with coupon issues from a slight easing in money market conditions and greater confidence in the strength of future wage-price policies. In yesterday's regular weekly auction, the average rates on three- and six-month bills were 4.74 and 4.99 per cent, respectively, compared with 4.75 and 4.86 per cent four weeks earlier.

Near-term Treasury financing plans are uncertain at this time. Some cash borrowing is likely in the first half of October, probably but not necessarily in the bill area. A market operation to achieve

> some debt lengthening is also a near-term possibility, but more likely such an effort will await the next quarterly refunding to be announced in late October.
>
> As expected, the System's announcement last Thursday of plans to engage in outright purchases and sales of Federal agency securities has generated considerable interest among participants in that market. The day following the announcement the System Account Management met with representatives of the dealer firms to discuss the published initial guidelines and to respond to questions about technical details of operations. We have not yet undertaken any purchases, but the prospective need to provide some reserves by the latter part of this calendar week may present the logical occasion for the System's first entry.

Mr. Daane asked Mr. Sternlight to expand on his comment that pursuit of easier money market conditions would not necessarily result in a decline in corporate interest rates unless growth in the aggregates was slowing.

Mr. Sternlight said his point was that an easing of money market conditions, if accompanied by further rapid growth in the aggregates, could engender renewed concerns about superabundant credit and thus have the perverse effect of adding to upward pressures on long-term interest rates.

In reply to a further question by Mr. Daane, Mr. Axilrod noted that according to the projections given in the blue book unchanged money market conditions would be associated with very moderate rates of growth in M_1 in September and October--at annual rates of 1.5 and 4.5 per cent, respectively. Growth in the bank credit proxy was projected to be somewhat stronger in those months--at rates of 8 and 6 per cent.

Mr. Daane then asked what implications such growth rates were likely to have for confidence.

Mr. Sternlight replied that in his judgment expansion of the aggregates at rates close to those Mr. Axilrod had mentioned would be consistent with rising confidence in the ultimate success of the whole anti-inflationary program.

Mr. Brimmer observed that there was very little difference between the growth rates Mr. Axilrod had cited, which were associated with alternatives A and B in the blue book, and those for September and October associated with alternative C. However, the money market specifications differed considerably; for example, the range for the Federal funds rate was shown as 5 to 5-5/8 per cent under A and B and as 4-1/2 to 5 per cent under C. He asked whether Mr. Sternlight thought the outcome in terms of market reactions would be significantly different if the Committee adopted alternative C rather than A or B.

In reply, Mr. Sternlight noted that under either course, according to the blue book, the rates of growth in the monetary aggregates would be substantially below those experienced in recent months. If the aggregates were following the indicated paths, he would expect the market to accept readily the kind of money market easing that would be involved in a decline of the funds rate to the lower end of the 5 to 5-5/8 per cent range associated with alternatives A and B. However, an easing of

money market conditions as substantial as that called for under alternative C could generate concern about the System's ability to keep the aggregates under control over the longer term, and about the ultimate success of the anti-inflationary program.

Mr. Partee remarked that such terms as "significant" and "substantial" were relative terms, and to his mind it was an open question as to whether they could be appropriately applied under present circumstances to the amount of money market easing called for under alternative C. In any event, the similarity of the aggregate growth rates projected for the near-term under alternative money market conditions reflected the staff's belief that changes in money market conditions affected the growth rates on a lagged basis--a belief which was based on a considerable body of empirical evidence. If that were so, larger differences in M_1 growth rates under the two policy alternatives would be expected in the first quarter of 1972. Accordingly, the real issue in the choice among the alternatives seemed to him to relate to the rates of growth in the aggregates that would be set in train for the longer run. While it was hard to make precise forecasts, the staff's best judgment at the moment was that the alternative A money market conditions would be associated with a first-quarter growth rate of M_1 only modestly above the 3.5 per cent rate projected for the fourth quarter, whereas under alternative C the first-quarter rate might be around 6 per cent.

Mr. Brimmer observed that in raising the question about probable market reactions he had been concerned primarily with the short run--specifically, with the period around the shift into Phase II.

Mr. Axilrod said he did not think a decline in the funds rate into the 4-1/2 to 5 per cent range called for under alternative C would stimulate a resurgence of inflationary expectations if M_1 were growing at the 1-1/2 per cent pace shown in the blue book for September. It was more likely that the market would interpret such an easing of conditions as reflecting an effort by the System to keep the money supply from getting weaker. The alternative C growth rate shown for October was 5-1/2 per cent, and perhaps that rate lay in a gray area with respect to effects on expectations. But even with such a growth rate he seriously doubted that there would be adverse market reactions--particularly if long-term interest rates were under upward pressure at the time.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 24 through September 20, 1971, were approved, ratified, and confirmed.

The Chairman then called for the go-around of comments on monetary policy and the directive. In view of the lateness of the hour, he suggested that those members who had prepared statements might want to summarize them and submit the full statements for inclusion in the record.

Mr. Hayes summarized the following statement:

> To me the economic outlook suggests a roughly unchanged stance in terms of money market conditions, although continuing signs of slower growth of the aggregates might warrant our moving toward the lower part of the 5 to 5-3/4 per cent Federal funds rate range established at the last meeting. I would certainly hope to avoid any decline in the funds rate sufficiently sizable to suggest to the market any significant easing of Federal Reserve policy. Member bank borrowings of $400 to $600 million and net borrowed reserves of $200 to $400 million would probably be consistent with such a funds target, and we might look for bill rates between about 4.70 per cent and 5 per cent or a little over.
>
> As for the directive, I prefer alternative A. I could live with alternative B, but I like the specific reference to moderate growth "over the months ahead" in alternative A. And, while I recognize that account must be taken of capital market developments, I have some fear that reference to this factor in the directive, as called for in alternative B, could give the impression of excessive emphasis.
>
> I would like to add just one brief observation on the Administration's current strong stance with respect to interest rates. For the time being this should not present the System with any problems, as long as there is a sizable cushion between current rate levels and those of August 13. However, the cushion is not so large as to give me any feeling of assurance that the Administration's rate policy will not become a serious obstacle to effective monetary policy. Obviously, much depends on the course of credit demands associated with a reviving economy and a very large Federal deficit, as well as with the degree to which inflationary expectations may be dampened under the very important Phase II policy. We can only hope that these developments will work out in such a way that the System will not be confronted with a most difficult policy dilemma.

In reply to a question by the Chairman, Mr. Hayes said that in speaking of the "Administration's rate policy" he had meant the apparent disposition to keep interest rates below their August 13 levels.

Chairman Burns remarked that he did not think the Administration had any formal policy with respect to interest rates at this time.

Mr. Coldwell said he favored a policy of stability with only mild encouragement to reserve creation over the coming weeks and months. Since the economic outlook was still highly uncertain, he thought the Committee should keep a tight rein on reserves for the time being. He preferred the alternative A language for the second paragraph of the directive. However, he would suggest specifications for money market conditions in a middle ground between those shown in the blue book under alternatives A and C, including a range of 4-3/4 to 5-1/4 per cent for the funds rate. With regard to the staff's draft of the first paragraph of the directive, he was unsure of the meaning of the sentence reading "Negotiations looking toward further actions to adjust international payments have begun," and he thought that statement could be improved upon.

Chairman Burns remarked that Mr. Coldwell's criticism was valid. He asked the staff to consider possible means of clarifying the statement.

Mr. Morris said that either alternative A or B would be acceptable to him. He thought the Committee should move slowly in easing money market conditions at this juncture. He would favor permitting the funds rate to decline to 5 per cent over the next four weeks; since some progress had been made in slowing growth in the aggregates, such a reduction should not create any problems.

In his judgment, however, it would be premature to call at this meeting for the amount of easing contemplated under alternative C. At its next meeting the Committee should be able to make a better assessment of the economy's response to the new economic program, and it would know something about the nature of Phase II.

Mr. Swan said he also could accept either alternative A or B, although he had a slight preference for the wording of B. He shared Mr. Coldwell's preference for money market specifications overlapping the two sets proposed by the staff. However, he would widen the range for the Federal funds rate to 4-1/2 to 5-1/2 per cent, on the understanding that any reduction in the rate would follow rather than lead the market. He saw no reason why the funds rate should not be allowed to go as low as 4-1/2 per cent if the aggregates slackened further, or to rise to 5-1/2 per cent if they strengthened significantly.

Mr. MacLaury remarked that a directive with a primary instruction formulated in terms of money market conditions seemed to him to be desirable at this time. It was particularly difficult at present to determine the appropriate rates of growth in the monetary aggregates; there were uncertainties with respect to the effects of large international flows of funds and the consequent wide swings in Government deposits, and also with respect to the potential impact on liquidity requirements of changing price expectations. Furthermore, as Mr. Morris had pointed out, the

Committee was not yet in a position to assess the economy's response to the new program, and it lacked information about Phase II. The importance of avoiding substantial increases in market interest rates was another reason for focusing on money market conditions. Although as the Chairman had indicated the Administration did not have a formal policy with respect to interest rates, it seemed highly likely that any tendency of rates to move above their mid-August levels would create problems.

For such reasons, Mr. MacLaury said, he would propose a second paragraph for the directive--which might be labeled "alternative D"--reading as follows: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the money market conditions recently prevailing; provided that money market conditions shall be modified if it appears that the monetary and credit aggregates are falling significantly below the growth paths expected." As for the money market conditions to be maintained, he also would favor conditions intermediate to those associated with alternatives A and C. Specifically, he thought the funds rate should be kept within about one-fourth of a percentage point of 5 per cent.

Chairman Burns observed that the money market conditions Mr. MacLaury had suggested seemed to be inconsistent with his proposed directive language calling for maintaining "recently prevailing" conditions.

Mr. MacLaury agreed that the language he had proposed was in need of modification to remove that inconsistency.

Mr. Mayo noted that he had some reservations about adopting a directive along the lines of alternative D at this time despite the fact that he was generally inclined toward a money market orientation for the Committee's directives. Rather than calling for some specific funds rate or for some predetermined decline in the rate, he thought it would be better to instruct the Manager to make operating decisions during the coming period in light of the actual course of the aggregates. He would prefer a wider band for the funds rate than specified under alternative A--perhaps a range of 4-3/4 to 5-1/2 per cent. He would favor having the Desk provide gentle encouragement to a decline in the rate within that range if the aggregates appeared to be following the alternative A paths.

As to the second paragraph of the directive, Mr. Mayo said he had a slight preference for B over A. With respect to the draft of the first paragraph, he noted that real output of goods and services was said to be expanding "moderately." In his judgment, some such word as "slowly" would be more accurate.

After discussion, the Committee agreed that the word "moderately" should be replaced by "modestly."

Mr. Clay remarked that the Committee continued to be faced with a high degree of uncertainty as to future economic and financial

developments in both the domestic and international areas. However, on balance, changes in both monetary aggregates and interest rates had been favorable since the President's announcement of his new economic program on August 15. With so much unknown about important relevant future developments on both the political and economic fronts, it would appear prudent for the Committee to take a cautious approach in formulating its policy.

The appropriate course for the period ahead seemed to be represented by alternative A, Mr. Clay said. Considering the large growth rates in the monetary aggregates earlier in the year and the accompanying growth in liquidity, the current and prospective near-term moderate growth rates should be quite satisfactory.

The projected range of 5 to 5-5/8 per cent for the Federal funds rate seemed reasonable to Mr. Clay. However, if the Federal funds rate were to drop below 5 per cent as a result of market forces and that proved compatible with the other specifications for A, it need not be a matter of concern. Under those circumstances such a development probably would prove encouraging to the capital markets. That type of influence on capital markets would be distinctly preferable to any evidence of aggressive Committee effort to bring long-term interest rates lower, in terms of its effect on both the stability of the capital markets and inflation psychology.

Mr. Heflin summarized the following statement:

> The language of either alternative A or B can accommodate my view of what the posture of policy should be over the next inter-meeting period. In view of the possibility that protracted uncertainty in the international area could react back on our financial markets, I think I would prefer the language of B, although I would include some reference to our concern with developments in the international exchanges as well as in our capital markets. I continue to feel, however, that the main thrust of policy should be directed at achieving and maintaining growth in the aggregates of the order of 5 to 6 per cent per year. I should hope that it will be possible to do this while at the same time moving to nudge interest rates--especially bond yields--down somewhat.
>
> The latest projections suggest that these two objectives are compatible, although I must express some skepticism here. While I welcome the evidence of a significant slowing in the aggregates over the last six weeks, I am also impressed with the fact that the slowing has been mainly in those aggregates heavily influenced by the recent international money flows. The adjusted proxy continues to move ahead at a pace that I cannot consider moderate. Under the circumstances, I think it would be premature to assume that we have won the battle of the aggregates.
>
> For the present, I think the safest course is to instruct the Desk to maintain the funds rate in a 5-1/4 to 5-1/2 per cent range and to work it slowly down to 5 per cent, or even to 4-3/4 per cent, if it appears that the aggregates are failing to achieve the paths associated with A and B. I would also suggest that for the next few weeks, we assign somewhat greater significance than heretofore to the credit proxy, although I should not like to see M_1 and M_2 fall much below a 5 per cent path for more than a month or two.

Mr. Mitchell said he agreed that the present was a period of unusually poor economic visibility. For that reason, he believed the Committee should focus today on its policy for the next four

weeks. He was willing to accept Mr. Axilrod's prognosis for the near term, but he thought the latter had gone beyond his depth in his comments about the fourth quarter as a whole.

Mr. Mitchell noted that he did not like any of the directive alternatives the staff had submitted. He thought the directive language should reflect a greater awareness of the imprecision of the projections of the aggregates. The Committee, including himself, had created a problem by using directive language which suggested that it was following a narrow monetarist approach to policy. In fact, the Committee had been trying to take account of the various forces that influenced the monetary aggregates, but the market tended to focus exclusively on the rates of growth in the aggregates and to overreact to small changes.

In his judgment, Mr. Mitchell continued, the Committee also had made difficulties for itself by limiting fluctuations in the Federal funds rate and thus fostering the view that that rate was a reliable short-run indicator of the stance of policy. The situation would be healthier if the funds rate were permitted to fluctuate more in response to market forces. Mr. Swan had suggested a range of fluctuation in the coming period of 4-1/2 to 5-1/2 per cent; he would favor the somewhat wider range of 4-1/2 to 5-3/4 per cent.

Returning to the directive, Mr. Mitchell said he would suggest the following language: "To implement this policy, until

its next meeting the Committee seeks to maintain about the recently prevailing money market conditions, which it believes will accommodate an appropriate growth in money and credit aggregates. However, operations shall be modified if money aggregates appear to be resuming the high rates of growth prevailing earlier in the year." That language resembled Mr. MacLaury's alternative D, although the proviso clauses were different.

In response to a question Mr. Mitchell remarked that, while it was difficult to say what precise growth rates in the aggregates would be appropriate under present circumstances, he would be prepared to accept a September growth rate for M_1 anywhere in the range of, say, zero to 5 per cent.

Mr. Daane said his position was essentially similar to Mr. Mitchell's. From the staff's responses to his earlier questions he had concluded that the maintenance of money market conditions about like those currently prevailing would be consistent with moderate growth in the monetary aggregates and, more importantly, with the objectives of the new economic program and with a general reinforcement of confidence. He would favor giving greater latitude to the Desk with regard to operating decisions, and he would not want to specify any narrow range for the Federal funds rate. As to the directive, he supported the spirit of Mr. MacLaury's and Mr. Mitchell's proposals. He had no strong feelings about the specific choice of language and could accept either version.

Mr. Hayes noted that the proviso clauses in the two versions differed considerably. Under Mr. MacLaury's proposal operations would be modified only if the aggregates were falling significantly below the expected paths, whereas Mr. Mitchell's language called for modification only if the earlier high growth rates resumed.

Mr. Daane suggested that in place of either of those one-way provisos a two-way clause might be used. In view of the uncertainties about the effects of international flows of funds on the aggregates, he thought the proviso should not be implemented unless the deviations were marked.

Mr. Mitchell observed that the staff had projected growth in M_1 in September at an annual rate of 1-1/2 per cent. Since, as he had indicated, a growth rate in the zero to 5 per cent range was acceptable to him, he would have no objection to a two-way proviso.

Chairman Burns said he thought Mr. Mitchell's proposed language suffered from the same difficulty as Mr. MacLaury's proposal in that it called for maintaining about the money market conditions now prevailing. Perhaps it should be revised to call for maintaining conditions in the lower end of the recently prevailing range. He thought that type of revision would reflect Mr. MacLaury's intent, and he asked whether it also reflected Mr. Mitchell's.

Mr. Mitchell remarked that the proposed revision would appear to narrow the acceptable range of money market conditions. That was contrary to his view that money market conditions should be permitted to fluctuate over a wider range.

Mr. Maisel said he did not like the directive proposals of Messrs. MacLaury and Mitchell because they seemed to imply that the Committee had no specific goals. It was important that the Committee not get trapped again into selecting policies which looked only at the situation up to the next FOMC meeting. As Mr. Partee had indicated, the aggregates reacted to changes in money market conditions with a lag. Thus, the money market conditions maintained during the coming month would have consequences for the changes in the aggregates over the rest of the year and in the first quarter of 1972. Admittedly, the projections of the aggregates were imprecise. Nevertheless, it was important that the Committee use the best information available to it to select a proper goal and to arrive at a judgment about the desirable rates of growth in the aggregates over the months ahead.

In his view, Mr. Maisel continued, the desirable growth rates at this time were those that would best complement the Administration's new economic program. In particular, funds should not be supplied at a pace below the normal growth of demands. If the level of economic activity portrayed by the staff's GNP projections was reasonable--and he thought it was--it would follow that the aggregates should expand at rates at least as rapid as those shown under alternative C in the blue book; slower expansion would almost certainly be associated with rising interest rates.

Mr. Maisel said that while he hoped interest rates would decline, he agreed with Mr. Sternlight that any effort by the System to force them down was likely to produce perverse reactions. That did not mean, however, that the reduction in the Federal funds rate which would be required to achieve the alternative C growth rates for the aggregates was not feasible. He favored the directive language shown under alternative A, but he would attach the alternative C specifications to that language on the understanding that the funds rate would be moved down gradually within the indicated range over the course of the next four weeks. He thought that somewhat greater flexibility in the funds rate should be permitted as its average level declined.

Mr. Brimmer said he would favor a directive along the lines of those proposed by Messrs. MacLaury and Mitchell. Also, he agreed that the Federal funds rate should be permitted to fluctuate over a wider range.

Mr. Sherrill expressed the view that a money market focus for the directive would be desirable, at least for a short period, in light of the great uncertainties at present about the factors that were influencing the monetary aggregates. Accordingly, he favored some version of alternative D for the directive. At the same time, he agreed with Mr. Maisel that the Committee should seek to avoid unduly low growth rates in the aggregates over coming months. He thought a range of 4-1/2 to 5-1/2 per cent would

be appropriate for the Federal funds rate, and he would not want to have the Desk discourage declines within that range.

Mr. Winn remarked that he would not attempt to contribute to the discussion of the directive. In general, with so much attention focused at present on Phase II of the Administration's program, he thought the best course for the Committee was to come as close as possible to neutrality in its policy.

Mr. Eastburn said he agreed with Mr. Maisel that the Committee should set goals for policy. Looking to the longer run, he thought the appropriate goal at this time was a conservative rate of growth in the aggregates. He favored flexibility in money market rates, but he believed it was important to avoid the impression that the System was attempting to force short-term interest rates down. On balance, he preferred alternative A for the directive.

Mr. Kimbrel observed that in his opinion the Committee's options were somewhat limited. On the one hand, it probably should not allow interest rates to go above their mid-August levels. On the other hand, if it permitted too rapid a rate of money supply growth it could undermine anti-inflation efforts and risk a loss of confidence which could be ill afforded. He favored a cautious and neutral policy--one that avoided injecting large amounts of reserves and producing sharply lower money market rates. Inasmuch as money supply growth during the first half of the year had been excessive, two or three months of slow growth should not interfere

with expansion of the economy. Later in the year, credit demands could strengthen and push up interest rates. Then, if the Committee still felt compelled to keep interest rates from rising very much, its actions could produce rapid money growth and risk an increase in inflationary expectations. That, it seemed to him, was a further argument for holding to a moderate or even to a slow rate of money growth as long as possible.

Mr. Kimbrel noted that the policy course he favored seemed best described by the specifications given for alternatives A and B. As to language, he preferred alternative A but would have no trouble in accepting B.

Mr. Francis said it seemed to him that monetary actions since mid-August had been appropriate. He would like to see the Committee adopt alternative A as proposed by the staff. A faster rate of monetary injection might contribute to greater underlying inflationary pressure, while a slower pace could trigger a slowdown in the recovery of real product growth. It was his hope that the Administration's program as finally formulated would not include interest rate controls.

Mr. Robertson summarized the following statement:

> I think we can take some gratification from the way our financial system has performed since our last meeting. Interest rates have stayed well below their August 15 levels; the money supply has finally slowed down markedly; and other key monetary aggregates are behaving well.

> These are encouraging results. No one can be sure, of course, how long this favorable turn of events will continue. I suppose the most important determinant of the future will be what the President unveils as Phase II policy and how it is accepted. Until that becomes clear, we shall have to make monetary policy in a climate containing a larger than usual degree of uncertainty.
>
> I take it that the best policy course for us to follow in the interim is to foster financial conditions that promise to promote stability, insofar as we can judge that, taking care to avoid extremes. I do not mean to sound concerned about the relatively low August-September M_1 estimates; they follow several months of too-high M_1 numbers, and by themselves these current months are too brief and too full of temporary but unusual influences to be taken as indicative of any adverse trend. What I think is called for, from the point of view of the aggregates, is an orderly supplying of reserves in amounts sufficient to sustain moderate growth in M_1 and M_2.
>
> Insofar as interest rates are concerned, I expect and hope that this reserve supply strategy will be consistent with a gradual further downdrift in the Federal funds rate. That, too, is a desirable objective, in my judgment, in order to keep markets reasonably accommodative. I do not know what interest rate level is precisely right today, but I do feel reasonably sure that the general direction of rate movements for the present should be level to downward and we should not attempt to keep them from dropping. On the other hand, we should act to forestall any rate run-up so substantial as to rise above mid-August levels.
>
> In sum-up, my policy prescription is for an orderly supplying of reserves at a gently declining funds rate, with an eye to moderate growth in the aggregates and no big backup in interest rates. I believe alternative B for the directive as drafted by the staff can encompass these objectives. However, alternative A or C also would be acceptable to me.

Mr. Robertson added that he was disturbed by the suggestions in the discussion today that the Committee should use the Federal

funds rate, or money market conditions generally, for target purposes. He had thought that the Committee had been moving away from such targets. He would not want to direct the Manager to aim at any specific level for the Federal funds rate; rather, the objective should be to supply reserves at the pace that seemed likely to result in moderate growth in the aggregates.

Chairman Burns remarked that it was rather difficult to summarize the thinking of the Committee today. A majority of the members had expressed a preference for either alternative A or B of the staff's drafts, but there also was a substantial body of sentiment for some version of alternative D. The strength of that sentiment was not entirely clear, since D had been proposed in the course of the go-around and not all members had had an opportunity to comment on it. Also, there was still some question as to how the language of D might best be formulated. He asked the members to indicate whether they were inclined to follow the general approach of alternative D, setting aside the question of specific language for the moment.

Five members expressed such an inclination.

The Chairman then asked the members to indicate whether they would be reasonably content with first, alternative A, and second, alternative B.

Seven members responded affirmatively in connection with A and five in connection with B, with some members recording themselves in both groups.

Chairman Burns then noted that a specific proposal for alternative D language had been worked out which the members might want to hear. That language was as follows: "To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to approximating, on the average, the lower end of the range of recently prevailing money market conditions, which the Committee believes will accommodate appropriate growth in monetary and credit aggregates. However, operations shall be modified if it appears that the monetary and credit aggregates are deviating markedly from the growth paths expected."

Mr. Mayo asked whether such language would preclude a funds rate below 5 per cent. He thought that would be an important consideration in deciding whether the proposal was acceptable.

The Chairman said that in his judgment a funds rate below 5 per cent would not be precluded. If market forces were tending to drive interest rates down he would not want the Desk to try to offset them.

Mr. Mitchell asked whether the proposed language would be consistent with a range of 4-1/2 to 5-3/4 per cent for the funds rate.

Chairman Burns replied that he personally thought it would be. If the Committee so chose, it could attach that specification to the language.

Mr. Maisel expressed the view that the approach under discussion would leave the Desk with inadequate guides to operations.

Mr. Brimmer suggested that Mr. Sternlight be asked how he would interpret the Committee's intent if it approved the proposed language.

Mr. Sternlight replied that, as he understood it, the Desk would be expected to follow specifications intermediate to those associated with alternatives A and C in the blue book. Thus, the funds rate might fluctuate around a midpoint in the neighborhood of 5-1/8 or 5-1/4 per cent, perhaps dipping down to 5 per cent or below on occasion.

Chairman Burns remarked that, on balance, he would favor a funds rate below 5 per cent only if the aggregates were misbehaving.

Mr. Partee noted that if the aggregates were deviating markedly from expectations, under the terms of the proposed proviso clause the Desk would be expected to seek money market conditions outside the range initially specified.

Mr. Mitchell said he was not sure what meaning would be attached to the phrase "appropriate growth in money and credit aggregates." Mr. Maisel had indicated that he would not favor a shortfall from normal growth rates even in the month ahead, whereas

he (Mr. Mitchell) thought a sizable shortfall would not be undesirable in the short run, in light of the very high growth rates of recent months. While he was inclined to agree with Mr. Maisel with respect to the longer run, he believed the best course for the Committee today was to focus on the near term and not attempt to make a judgment as to the precise growth rates that would be appropriate for a more extended period.

Mr. Brimmer concurred in Mr. Mitchell's view.

Mr. Maisel remarked that while he did not disagree with the proposal for a short-run focus, he still considered it important to give the Desk specific instructions. Specifications between those associated with alternatives A and C, as Mr. Sternlight had suggested, would be agreeable with him. He would propose ranges of $400 million to $500 million for member bank borrowings and 4-3/4 to 5-1/4 per cent for the Federal funds rate.

Mr. Mitchell observed that the Committee had had a more extensive discussion of its objectives today than often was the case. Mr. Daane added that the Desk was guided not only by the language of the directive but also by the Committee's discussion.

Chairman Burns then asked the members to indicate whether they would favor the version of alternative D he had read.

When four members responded affirmatively, the Chairman said the choice of language evidently lay between alternatives A and B.

He asked Mr. Partee to indicate the precise nature of the difference between those alternatives.

Mr. Partee observed that B differed from A in two respects. First, B had a shorter-term focus than A, as indicated by the omission of the words "over the months ahead" following the reference to growth in the aggregates. Secondly, B included an additional instruction to take account of developments in capital markets. In effect, that reference would require the Desk to seek easier money market conditions if interest rates in capital markets were tending to rise significantly.

Chairman Burns noted that he had not commented on his personal preferences with respect to directive language up to this point. However, he would say now that he thought B was clearly preferable to A because of its near-term focus. In light of the many prevailing uncertainties, including those associated with the new economic program, he would consider it undesirable for the Committee to take a stance at this time with respect to appropriate policy for the longer run.

Mr. Hayes observed that in explaining his preference for alternative B the Chairman had mentioned only the question of the time period covered. He asked whether it was the sense of the Committee that it also would be desirable to include the proposed instruction to take account of capital market developments. Personally, he was concerned that such an instruction might require

the Desk to reduce the funds rate far enough to produce a perverse reaction in capital markets.

Chairman Burns commented that, while the shorter-term focus of B had been decisive in his preference for that alternative, he also was inclined to feel that the reference to capital market developments was desirable.

Mr. Mitchell said he would favor including either the proposed reference or some other language that conveyed the same instruction. He thought such an instruction was needed, at least for the time being.

Mr. Robertson agreed, adding that he was concerned about the risk of a significant rise in long-term interest rates.

In response to a question, the Chairman said he would not favor adding an instruction to take account of international financial developments. Under present circumstances, the extent to which such developments should be permitted to affect monetary policy was far from clear.

Mr. Holland noted that the Committee had agreed earlier to revise the staff's draft of the first paragraph to indicate that output was expanding "modestly" rather than "moderately." Also, following a comment by Mr. Coldwell, it had asked the staff to consider means of clarifying the sentence relating to international negotiations. The revised sentence the staff proposed read as follows: "Negotiations have begun on additional measures to reduce

payments imbalances and on other improvements in the international monetary system."

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

The Chairman then suggested that the Committee vote on a directive consisting of the staff's draft of the first paragraph with the two changes Mr. Holland had mentioned, and alternative B for the second paragraph.

> By unanimous vote, 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 the Government's new economic program has reduced inflationary expectations and has improved prospects for higher rates of growth in real economic activity and employment. In the current quarter, however, real output of goods and services is expanding modestly and unemployment remains substantial. Prior to the imposition of the 90-day freeze, prices and wages were rising rapidly on average. In August inflows of consumer-type time and savings funds to nonbank thrift institutions moderated and inflows to banks remained at a reduced rate. Growth in the narrowly defined money stock, which had been rapid through July, slowed sharply in August; and growth in broadly defined money continued to slacken. However, the rate of expansion in the bank credit proxy stepped up, mainly reflecting a marked rise in U.S. Government deposits. Market interest rates, which declined sharply following the announcement of the new program, have since fluctuated irregularly. The U.S. balance of payments continues to be in a position of substantial basic deficit. Speculative capital outflows have diminished recently.

Most major foreign currencies are trading in the exchange markets at rates against the dollar a few per cent higher than on August 13. Negotiations have begun on additional measures to reduce payments imbalances and on other improvements in the international monetary system. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to achieve moderate growth in monetary and credit aggregates, taking account of developments in capital markets. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, October 19, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

September 20, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on September 21, 1971

FIRST PARAGRAPH

The information reviewed at this meeting suggests that the Government's new economic program has reduced inflationary expectations and has improved prospects for higher rates of growth in real economic activity and employment. In the current quarter, however, real output of goods and services is expanding moderately and unemployment remains substantial. Prior to the imposition of the 90-day freeze, prices and wages were rising rapidly on average. In August inflows of consumer-type time and savings funds to nonbank thrift institutions moderated and inflows to banks remained at a reduced rate. Growth in the narrowly defined money stock, which had been rapid through July, slowed sharply in August; and growth in broadly defined money continued to slacken. However, the rate of expansion in the bank credit proxy stepped up, mainly reflecting a marked rise in U.S. Government deposits. Market interest rates, which declined sharply following the announcement of the new program, have since fluctuated irregularly. The U.S. balance of payments continues to be in a position of substantial basic deficit. Speculative capital outflows have diminished recently. Most major foreign currencies are trading in the exchange markets at rates against the dollar a few per cent higher than on August 13. Negotiations looking toward further actions to adjust international payments have begun. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee seeks to achieve moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective.

Alternative B

To implement this policy, the Committee seeks to achieve moderate growth in monetary and credit aggregates, taking account of developments in capital markets. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective.

Alternative C

To implement this policy, the Committee seeks to promote moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective.