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, October 17, 1972, at 11:15 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Bucher
Mr. Coldwell
Mr. Daane
Mr. Eastburn
Mr. MacLaury
Mr. Mitchell
Mr. Robertson
Mr. Sheehan
Mr. Winn

Messrs. Francis, Heflin, and Mayo, Alternate Members of the Federal Open Market Committee

Messrs. Morris, Kimbrel, Clay, and Balles, Presidents of the Federal Reserve Banks of Boston, Atlanta, Kansas City, and San Francisco, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Altmann and Bernard, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. O'Connell, Assistant General Counsel
Mr. Partee, Senior Economist
Mr. Axilrod, Economist (Domestic Finance)
Messrs. Boehne, Bryant, Gramley, Green, Hersey, Hocter, and Link, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. Melnicoff, Deputy Executive Director, Board of Governors

Mr. O'Brien, Special Assistant to the Board of Governors
Mr. Reynolds, Associate Director, Division of International Finance, Board of Governors
Messrs. Keir, Pierce, Wernick, and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Mrs. Sherman, Secretary, Office of the Secretary, Board of Governors

Mr. Leonard, First Vice President, Federal Reserve Bank of St. Louis
Messrs. Eisenmenger, Parthemos, Scheld, Andersen, Tow, and Craven, Senior Vice Presidents, Federal Reserve Banks of Boston, Richmond, Chicago, St. Louis, Kansas City, and San Francisco, respectively
Messrs. Brandt and Doll, Vice Presidents, Federal Reserve Banks of Atlanta and Kansas City, respectively
Mr. Sandberg, Manager, Acceptance and Securities Departments, Federal Reserve Bank of New York
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis

Chairman Burns welcomed Mr. John J. Balles, who had recently taken office as the President of the Federal Reserve Bank of San Francisco, to his first meeting of the Committee.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on August 15, 1972, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee on August 15, 1972, was accepted.

The reports of audit of the System Open Market Account and of foreign currency transactions, made by the Board's Division of Federal Reserve Bank Operations as at the close of business August 18, 1972, and submitted by Mr. McWhirter, Chief Federal Reserve Examiner, were accepted.

Chairman Burns then noted that today's meeting of the Committee had begun at a later hour than planned because of the joint meeting of the Board of Governors and Reserve Bank Presidents that had been held earlier this morning. In the interest of using the remaining time most effectively, he suggested that the staff members reporting to the Committee be asked to summarize their prepared statements and submit the full texts for inclusion in the record.

There was general agreement with the Chairman's suggestion.[1/]

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 September 19 through October 11, 1972, and a supplemental report covering the period October 12 through 16, 1972. Copies of these reports have been placed in the files of the Committee.

Mr. Coombs summarized the following comments, prepared in supplementation of the written reports:

1/ In the interest of saving time at the meeting, Mr. Daane did not offer comments he had planned to make at this point regarding the recent annual meeting of the International Monetary Fund and World Bank. The text of his intended remarks is appended to this memorandum as Attachment C.

Since the last meeting of the Committee there has been a convergence of developments favoring the dollar on the foreign exchange markets. Our trade figures for August looked better, the atmosphere of the recent IMF meeting was conciliatory, short-term interest rates here have moved up in relation to European rates, and European inflation continues to run well ahead of our own. More generally, there has been a growing feeling in the exchange markets that, so far as the dollar is concerned, the worst is probably behind us while in the case of Europe the crunch is still to come.

Against this background, a return flow of short-term funds from Europe has been developing over the past month or so, and it may eventually result in sizable reductions in European dollar reserves. Rates on all of the European currencies, except the French franc, have moved down sharply. The day before our intervention in German marks on July 19, the mark was trading at 2.15 per cent above par; this morning it is being quoted at only 0.4 per cent above par. Meanwhile, the Dutch guilder has fallen from 2.18 per cent above par to just about even par this morning. The Swiss franc and Belgian franc have moved down from their Smithsonian ceilings to rates of 1.1 and 1.4 per cent, respectively, above par. The floating sterling rate continues to show weakening tendencies, while the Bank of Italy has been forced to draw on its reserves to keep the lira at its current level slightly below par.

We have taken advantage of these declines in European currency rates not only to step up our purchases of German marks and Swiss francs, but also to inaugurate a new program during the last week or so of regular daily purchases of Dutch guilders and Belgian francs. Since the last meeting of the Committee we have managed, through such market purchases, to pay down our swap debt by a further $70 million to a level of $1.7 billion, while simultaneously building up our foreign currency balances to a total of $150 million, comprised of $138 million of German marks, $3 million of Swiss francs, and $9 million of Dutch guilders. With respect to our current holdings of $138 million of German marks, I

think it would be worthwhile continuing to buy, if the mark rate continues to decline, up to a total of, say, $200 million. Such a stockpile would prove extremely useful in defending against any future speculative attack on the dollar. The mark is far and away the most important of the continental European currencies, with movements in its rates tending to act as a bellwether for other European currency rates. Quite aside from the potential use of such mark balances for future intervention, moreover, there remains the possibility of converting from time to time such mark balances into other currencies in which we are indebted, such as the Swiss franc and the Belgian franc. The Committee will recall that, in early September, we used about $10 million worth of mark balances to acquire Belgian francs through the market, and so paid off a swap drawing of $10 million of Belgian francs made last August.

The second major development in the exchange markets since our last meeting has been growing expectations of a shift in exchange rate policy by the Common Market countries. The Committee will recall that last spring the Common Market countries, together with the United Kingdom and Denmark, introduced the so-called "snake in the tunnel" policy which involved maintaining a band of no more than 2-1/4 per cent among the Common Market currencies through intervention exclusively in Common Market currencies. Intervention in dollars was ruled out until one or another Common Market currency should reach the ceiling or floor of the 4-1/2 per cent Smithsonian band. As outlined in our last semi-annual report, this exchange rate system created a virtual shooting gallery for the speculators during the sterling crisis last June. Sterling was artificially propped up above its Smithsonian floor and the stronger Common Market currencies were equally artificially dragged down below their Smithsonian ceilings, so the speculators had a two-way opportunity to profit.

Shortly after the sterling breakdown, Italy secured a temporary exemption from the Common Market system which enabled the Bank of Italy to keep the lira within the 2-1/4 per cent "snake" by intervening in dollars rather than by selling currencies borrowed from its Common Market partners. The Italian solution thus

avoided the danger of a weak Common Market currency artificially pulling down the stronger European currencies, and thereby recreating the speculative opportunities that appeared during the sterling crisis. Since last June, the Bank of Italy has been selling dollars to defend the lira at a level slightly below par, while the French franc, currently the strongest of the Common Market currencies, has remained fairly close to its ceiling. On the other hand, such intervention in dollars by the Bank of Italy, at rates at or slightly below par, has had the result of effectively narrowing the Smithsonian band, so far as Italy is concerned, from 4-1/2 per cent to only slightly more than 2-1/4 per cent. While the Common Market countries have not yet reached a final decision on correcting the technical deficiencies of the "snake in the tunnel" policy, I think there is some likelihood that the exemption granted to Italy may soon be generalized to cover all of the Common Market countries.

The Smithsonian band of 4-1/2 per cent may also be squeezed into a much narrower spread by recent policy decisions of both the Common Market countries and Switzerland to sell dollars from official reserves as soon as their exchange rates approach par rather than waiting until they decline by a further 2-1/4 per cent to their Smithsonian floors. Most of the European central banks remain anxious to reduce their uncovered dollar holdings, not only to lessen their exchange risk but also to absorb excessive domestic liquidity. Accordingly, on October 2, as the Swiss franc declined to roughly 1 per cent above par, the Swiss National Bank began to release dollars to the market, and in the course of the day disposed of more than 200 million uncovered dollars. In retrospect, I think the Swiss National Bank might better have intervened on a more graduated scale. By intervening instead in such heavy volume, the Swiss National Bank seems to have given the market the impression of introducing a fairly firm new floor for the Swiss franc, and thereby halted the recovery of the dollar rate against the Swiss franc. Since then the growing strength of the dollar has reasserted itself, and I hope the Swiss National Bank will allow the dollar

rate to rise above the previous intervention point before intervening to sell dollars once again. Last week the German Federal Bank, the Netherlands Bank, and the National Bank of Belgium also began to feed out dollars to the market but on a relatively small scale, and without interrupting the rising trend of the dollar rate.

In general, I would say that European central bank intervention to sell dollars somewhere around par levels will probably enable them to sell more dollars than if they waited, perhaps indefinitely, for their currencies to decline to the Smithsonian floors. On the other hand, they should be careful to feed the dollars out gradually, leaving if possible a certain margin of unsatisfied demand and thereby encouraging a continuing buoyancy in the dollar rate.

Mr. Brimmer asked whether the British were likely to end the sterling float before the first of the year, when Britain was scheduled to become a member of the Common Market.

Chairman Burns said he understood that the British authorities were seriously considering such an action. He could not say what decision they were likely to reach.

Mr. Coombs added that the problem was a difficult one for the British. In his judgment they would have difficulty in defending a new par value unless they developed a reasonably effective incomes policy.

By unanimous vote, the System open market transactions in foreign currencies during the period September 19 through October 16, 1972, were approved, ratified, and confirmed.

Mr. Coombs then reported that a number of System drawings in Belgian and Swiss francs would mature soon. These included 8 drawings on the National Bank of Belgium, totaling $325 million, which matured for the fifth, sixth, or seventh time in the period November 3-24, and 2 drawings on the Swiss National Bank, totaling $640 million, which matured for the fifth time on November 10 and 17. They also included 2 drawings on the Bank for International Settlements maturing for the fifth time--a $600 million Swiss franc drawing due on November 13 and a $35 million Belgian franc drawing due on November 17. While he hoped to repay some of those drawings before maturity, he thought it would be necessary to renew most of them. Since the swap lines in question had been in continuous use for more than a year, under the terms of paragraph 1D of the foreign currency authorization specific approval by the Committee was required before the drawings could be renewed.

In response to a question by the Chairman, Mr. Coombs said he thought the System was making the maximum feasible progress in repaying its outstanding drawings by market purchases of foreign currencies. It might also prove possible to acquire a large volume of Swiss francs for that purpose in a direct transaction with the Swiss National Bank if and when that Bank had reduced its uncovered dollar holdings to, say, $500 million.

Mr. Brimmer asked why some of the System's Belgian franc acquisitions had not been used to repay the outstanding $35 million drawing in that currency on the BIS.

Mr. Coombs replied that it had seemed preferable to apply the francs in question to repayment of the System's debt to the National Bank of Belgium, in order to have as large a margin as possible available on the swap line with that Bank in the event of an emergency.

By unanimous vote, renewal for further periods of 3 months of the 8 System drawings on the National Bank of Belgium maturing in the period November 3-24, 1972, was authorized.

By unanimous vote, renewal for further periods of 3 months of the 2 System drawings on the Swiss National Bank maturing on November 10 and 17, 1972, respectively, was authorized.

By unanimous vote, renewal for further periods of 3 months of the 2 System drawings on the Bank for International Settlements, in Swiss francs and Belgian francs and maturing on November 13 and 17, 1972, respectively, was authorized.

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

Mr. Partee summarized the following statement:

There can be little doubt that the economy is now moving strongly upward again, following the temporary slowing in growth during late spring and early summer. That period of relative sluggishness will be reflected in third-quarter GNP estimates to be published by the Department of Commerce late this week. We understand the indicated increase in GNP is likely to be below $23 billion, with real growth at somewhat under 6 per cent--both measures a little lower than estimated in the green book.1/ But, in real terms at least, the third-quarter average is not representative of the most recent developments. Nonagricultural employment--including jobs in manufacturing--rose strongly in both August and September. And the industrial production index, to be released today, shows an upward revision in the August rise to 0.7 per cent and a further September advance of 0.6 per cent, for a two-month gain averaging 8 per cent, annual rate.

More importantly, business and consumer expectations seem to have improved markedly recently. The District summaries contained in the red book2/ this month are unusually bullish, with hardly a sour note to be found anywhere, except for concern about future inflation. The latest monthly purchasing agents survey shows the strongest optimism in many years, with the proportion of firms reporting higher orders and output exceeding those indicating weakening by a large margin. The first private survey of 1973 plant and equipment spending plans--not yet released--indicates a 9 per cent increase over-all and a 13 per cent expansion in manufacturing. This is somewhat below our present 1973 projection but not at all inconsistent with it, given the tendency of these surveys to scale upward with the passage of time when business conditions are firming. Finally, two recent surveys of consumer attitudes--by the University of Michigan Survey Research Center and the National Industrial Conference Board--indicate notable improvement in sentiment over the summer months.

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

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

As it happens, the advance report of retail sales in September shows a 1-1/2 per cent decline. But sales for the third quarter as a whole were considerably higher than in the second quarter, and weekly sales reports for late September and early October again showed notable strength. New car sales, in particular, were exceptionally strong in late-September-early-October as the 1973 models were introduced. We figure the sales rate in the latest 20-day period at over 11 million units for domestic makes. Consumers have ample buying power to fuel their expanding appetites for goods. Personal income has been rising steadily, and consumer credit has expanded at a record pace. In early October, moreover, personal income flows began to be supplemented by an $8 billion increase in social security payments.

In early 1973 there will be an additional supplement to disposable income of similar size, reflecting refunds of 1972 personal taxes overwithheld this year. It appears that the larger and more numerous refund checks will come as windfall surprises to most taxpayers. The regular August survey by the University of Michigan included special questions on this subject--the first of a series supported by the Treasury Department and the Board--and the answers (not yet published) indicated that very few respondents were aware of the overwithholding problem, that even fewer had increased their number of exemptions claimed this year, and that a somewhat smaller proportion are expecting a refund next year than had actually received one in 1972. A sizable portion of this windfall may well be saved, but some will also be spent; we have assumed about a 50-50 distribution in our projection, spread over several quarters.

In general, I see nothing in the current picture that is inconsistent with the staff projection of accelerated economic expansion over the next two quarters and good growth for 1973 as a whole. Higher consumption is likely to generate additional demands for inventory, which should be communicated quickly to production schedules and continuing sizable gains in employment and hours. Rising output and sales, in turn, should stimulate further increases in business capital spending, extending at least throughout 1973. And rising employment, consumption, and investment

spending should lead to a sense of ebullience in the economy which, once it is in process, will tend to feed on itself. The outlook, in my view, is very good, although I would prefer not to be held to any precise quantification until we can review the whole situation in preparation for the chart show that will be given at the Committee's November meeting.

The recent record with regard to wages and prices also has been good--in this case, better than we had been expecting. The increase in average hourly earnings in the private nonfarm economy, adjusted for interindustry shifts and for overtime in manufacturing, continued at a moderate 4-1/2 per cent pace in August and September. This is about the rate that has prevailed on average since January, according to revised data, and features unusually modest wage rate gains in construction, trade, finance, and services. The rate of increase in prices, on average, also appears to have moderated recently. The consumer price index rose at only a 3 per cent rate in August, with service prices continuing to advance much less rapidly than in other recent years; and the wholesale price increase slowed to a 3-1/2 per cent rate in September, as the rise in both farm product and industrial commodity prices slowed considerably. We continue to expect an acceleration in wage-price increases in the period ahead, as higher social security costs, a delayed increase in the minimum wage, firming labor markets, and a tapering off in productivity growth all contribute to upward cost pressures. But the recent performance is impressive and we may have misjudged the extent of the dampening in inflationary psychology--both in labor and product markets--that is actually now in train.

The resistance to new or intensifying inflationary pressures as the economy recovers may very possibly receive two important assists from Governmental policy, aside from the conduct of monetary policy. First, there now seems to be a good possibility that an effective spending ceiling will be voted by Congress in the next day or two. Even if it isn't, the mood favoring spending restraint appears now to be developing an impressive Congressional following, though this is difficult to detect in the heat of the election season. If Federal expenditures are importantly constrained, this would have potentially very significant marginal effects on the outlook for GNP and related demand pressures during 1973. Second, there

appears to be widespread support for continuation of some form of wage-price restraint program beyond the April expiration date of the present legislation. We plan to drop our assumption that the program will be terminated, and to see what a continuation on some credible basis might imply, in our November projection exercise.

In sum, monetary policy at this juncture faces some significant imponderables. Economic expansion shows clear indications of gathering a full head of steam in the months to come. But present utilization rates in the economy, as measured by most unemployment indicators and by current operating rates in manufacturing, are still very comfortable, and many would say excessive. Moreover, there is promise--though not certainty--that some help may come from Government in restraining excessive demand pressures in the period ahead, first from a spending ceiling or other effective constraints on Federal spending, and second from the possible extension of some variant of the wage-price restraint program--for which there appears to be widespread support--through most or all of 1973.

Under the circumstances, I think we should move very cautiously with regard to monetary policy. If the spending ceiling goes through and reasonably restrictive goals are set for the new wage-and-price-controls year that begins on November 15, there may not be much need to restrain private-sector demands through higher interest rates and tighter credit, at least for some time to come. On the other hand, it seems to me critically important to avoid any abrupt escalation in monetary expansion now that would help to fuel excessive spending later on. For the time being, I would like to see the Committee hold to a target for monetary expansion indexed by M_1 growth at around a 6 per cent annual rate. We are still strongly inclined to the view that this would imply a rising trend in interest rates, given the economic environment immediately in prospect. We may be wrong--particularly if the spending ceiling becomes law and inflationary expectations are dampened further--but if we are not I would urge that upward rate movements not be resisted, subject, of course, to the short-run requirements of Treasury financings and the need for reasonably orderly market adjustments. If the economy begins to call for inflated

> rates of money and credit expansion, this in itself will be a signal of the need for higher interest rates to restrain the logical counterpart--excessive growth in demands for goods and services later on.

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 September 19 through October 11, 1972, and a supplemental report covering the period October 12 through 16, 1972. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes summarized the following statement:

> The indefinite postponement of the changes in Regulations D and J radically changed the need for Desk action to supply reserves over the period since the Committee last met. As you know, most of the substantial reserve need anticipated for the period was expected to be met by the net release of about $1.5 billion of reserves as a result of the regulatory changes. Once the postponement became necessary, open market operations had to be used instead to supply reserves, with about $2 billion on average being supplied over the period.
>
> The monetary aggregates, particularly M_1, grew more moderately in September than had been anticipated in the blue book1/ path presented at the last meeting, with M_1 finally turning out a touch below even the far more moderate growth rate projected at that time by the New York staff. As a result, while the Desk was cautious in supplying reserves, the pressure on the money market was not as severe as had seemed likely at the time of the last meeting. Immediately after the meeting the Desk was attempting to achieve reserve conditions that would result in a Federal funds

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

rate of about 5-1/8 per cent, with a strong likelihood that still firmer money market conditions might be necessary later on to achieve the Committee's objectives. But as the moderation of M_1 growth was confirmed by incoming data, a funds rate somewhere between 5 and 5-1/8 per cent appeared more appropriate.

As far as RPD's are concerned, it appeared through much of the period that they were coming in below the lower end of the 9-1/2 to 13-1/2 per cent range envisaged. Since it was clear that this range was higher than the Committee really wanted, the Desk took no action to boost RPD's. Later in the period, RPD's moved into the range, but only because excess reserves were coming in substantially higher than anticipated. Without this phenomenon--which appears to be of no policy significance--RPD's would still be below the lower end of the range.

A somewhat steadier tone developed in the Government securities market over the period, following the earlier run-up in Treasury bill rates. The postponement of the D and J changes generated dealer anticipation of large System bill purchases. While over $600 million of bills were in fact purchased in the market, this was less than dealers had hoped for, partly reflecting the fact that the System acquired a similar amount of Treasury bills from foreign central banks who were selling. In yesterday's regular bill auction average rates of 4.82 and 5.13 per cent were established for three-month and six-month bills, respectively, up 19 and only 3 basis points from rates established at the auction just preceding the last meeting. Other short-term rates also edged higher--by about 1/8 of a percentage point--while the prime rate was generally up 1/4 of a percentage point to 5-3/4 per cent, except for two banks with floating rates that went to 5-7/8 per cent last Friday.

Longer-term interest rates--buoyed by Vietnam peace rumors and generally light calendars--were quite steady, and municipal bond rates actually declined over the period. The Treasury's cash auction of $2 billion of two-year notes was well received by the market, although secondary market interest in the new issue was not quite as aggressive as some market participants had anticipated.

While the atmosphere in the securities markets is better than a month or so ago, the Treasury's large cash needs and an anticipated growth in loan demand are apt to exert upward pressure on interest rates over

the remainder of the year. These pressures could be mitigated, particularly in the case of longer-term rates, if the corporate and municipal bond calendars continue to be relatively light, if Government spending restraints are adopted, if progress is made towards a settlement in Vietnam, and if inflationary pressures continue to moderate. The course of System policy actions--in turn dependent on the course of growth of the monetary and credit aggregates--is, of course, a crucial factor in the interest rate expectations of the market.

The Treasury, as you know, is expected to raise a substantial amount of cash and to pay off $1.2 billion of maturing Treasury securities in mid-November, and it may also raise cash by adding to the regular weekly Treasury bill cycle. At the moment there appears to be a possibility that the Treasury may have to run down its balance at the Federal Reserve before mid-November and perhaps even to run an overdraft, requiring offsetting open market operations. This suggests, should affirmative court action be taken on the proposed changes in Regulations D and J, that the latter half of November--when the reconstitution of the Treasury's balance will be absorbing reserves--might be a good time for implementation of the changes from a reserve standpoint.

Looking ahead, the blue book suggests that should the Committee desire an M_1 growth rate of 5 to 6 per cent, as in alternatives B and C of the directive,[1/] the associated RPD path will result in a further firming of money market conditions--perhaps a substantial one. While I cannot quarrel with the logic that underlies these suggested relationships, it should be pointed out that the New York staff projections indicate an M_1 growth rate for October-November somewhat slower than envisaged under alternative C--with no change in money market conditions. It would be too much to hope that the New York projections would turn out to be right 2 months in a row, but it at least serves to underscore the fact that our understanding of the relationships between monetary aggregates and interest rates--and our ability to forecast them--are something less than perfect.

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

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period September 19 through October 16, 1972, were approved, ratified, and confirmed.

Mr. Axilrod summarized the following statement on prospective financial relationships:

The nature of the policy decision confronting the Committee at this meeting appears to differ little in its essentials from the problem of the previous several meetings. To bring growth in the monetary aggregates down to moderate proportions--and to keep it there--would seem to entail rising interest rates over time, particularly in short-term markets, given the projected strength of economic activity and credit demands.

The staff has tried in various ways to clarify alternative approaches the Committee might take to this basic situation. We have attempted another variation on the theme in the blue book for the current meeting. In it, we have attempted to be clearer in laying out alternative targets--in contrast to projections--on which the Committee may wish to focus.

There is probably no need for me to repeat the statistical details of the various alternatives posed for Committee consideration. But there may be some value in analyzing the underlying economic considerations.

We believe that the rise in short-term interest rates of about 1/2 to 3/4 of a percentage point since mid-year (and more than 1-1/2 percentage points since early 1972) will be retarding demand for money sufficiently over the months ahead to slow growth in, say, M_1 to below the 8-1/2 per cent annual rate of the third quarter. To be explicit, we would project an M_1 growth rate of around 7 per cent for the fourth quarter--and also about that rate for the October-November period--if short-term rates were about unchanged from current levels. That projection is why the alternative A targets presented to the Committee--which include a 7 per cent M_1 growth--do not indicate the likelihood of any substantial near-term rise of interest rates.

As Mr. Holmes has noted, the New York Bank staff has a much weaker projection for M_1 in the months immediately ahead and for the fourth quarter. If that projection is correct, and if the Committee were to opt for the aggregate targets of alternative A--or for that matter, of alternative B and maybe even C--the implication would be that interest rates would decline.

Such differences in projections merely highlight the critical importance of distinguishing between targets and projections. For example, if the FOMC wishes to begin moving toward greater restraint on aggregate expansion than is contemplated under alternative A, it could adopt a target which holds growth in M_1, among other aggregates, to, say, a 6 per cent annual rate over the next 2 months. The possible interest rate consequences of that target are described under alternative B of the blue book. These interest rates are, on one view, the consequence of an aggregate target. However, the Committee could take these or other interest rates themselves as targets, if it wished, and instruct the Manager how to balance off possible inconsistencies between its aggregate and interest rate objectives.

If the staff is correct in its assessment of demand relationships, a 6 per cent M_1 target would entail a further rise in the funds rate and in other short-term rates. The 4-3/4 to 6 per cent range shown for the funds rate under alternative B represents our best estimate of the range through which the funds rate might have to move over the next several weeks as bank reserve growth is constrained to achieve the monetary aggregate targets. This range is determined on technical grounds and is, of course, subject to all the usual forecasting errors.

But in adjudicating among relationships that involve monetary aggregates and interest rates, the Committee has more options than the staff. Thus, on policy grounds, the Committee may wish at times to constrain the funds rate to a narrower range than technically seems feasible for a given aggregate objective. It may want to do so, for example, because of even-keel considerations. Such considerations will be operative over the next few weeks, but the size of the Treasury financing to be announced a week from Wednesday is not likely to be so large or the operation itself so difficult as to preclude some firming of the money market if that should prove necessary.

The Committee may wish to constrain interest rate movements--on either the up or down side--for other reasons. Financial markets may be in a particularly sensitive state. The balance of payments may, at times, be a factor. Or the Committee may simply sometimes feel that--given all the economic circumstances, including uncertainties about the demand for money--it would rather risk some deviation for a while in the aggregates than let interest rates move by substantial amounts, either up or down.

The impact of a possible Federal expenditure ceiling is important in assessing the rate outlook. It would, if effective, reduce Federal cash borrowing considerably in the first half of next year. And it would improve market psychology by showing that monetary policy would not be called upon to do the job of restraint alone. As a result, interest rate pressures over the longer run could be less than indicated in the blue book, written when prospects for an effective ceiling seemed less promising. Moreover, it is possible that enactment of the ceiling could, in conjunction with continued progress in peace negotiations, lead to short-run declines of interest rates, particularly longer-term rates, as the public moved out of liquid assets, including cash balances, to capture available relatively high longer-term yields.

In setting its targets, one approach the Committee might consider would be to take growth rates in the alternative B or C ranges as targets. If the blue book assessment of demand relationships is correct, short-term interest rates will rise; if we have overestimated demand, they will not.

Taking some account of even keel, allowing for the possibility that our estimate of demand relationships may be off, and considering the potential economic and credit market effects of the expenditure ceiling, the Committee may wish to constrain the upper limit of the funds rate to, say, 5-1/2 to 5-5/8 per cent in the interval between now and the next meeting, while still permitting a lower limit somewhat below the currently prevailing 5 to 5-1/8 per cent rate. Any tendency for the funds rate to rise might be relatively limited, of course, because of market conditions in an even keel period or because of the complex of aggregates and over-all interest rate tendencies that might emerge if prospects of peace and greater fiscal restraint come to be taken even more seriously by the market.

Mr. Mitchell asked Mr. Partee for his interpretation of the recent decline in prices in the stock market. He wondered whether it might reflect a view on the part of market participants that rulings of the Price Commission were going to have a serious effect on corporate profits.

In reply, Mr. Partee noted that the drop in stock prices had occurred only over the last four trading days and on a light volume of trading. He doubted whether market participants were strongly influenced by the prospective effects of price controls on profits; presumably they would know that a new controls year began on November 15, and it seemed unlikely that they would sell now in the expectation that the new program would bite substantially into profits. Market participants might have reacted to the improved prospects for enactment of a ceiling on Federal expenditures; if a ceiling reduced expenditures by $7 to $10 billion from what they otherwise would be, this along with income-multiplier effects could have an appreciable moderating influence on the course of GNP. Alternatively, shifts in prospects for peace in Vietnam might be affecting market psychology. Still another possibility was related to the recent domination of market activity by institutional investors, whose views tended to be similar and subject to abrupt short-term swings. Whatever the reason, it did seem that recent market behavior was at odds with all other indicators of business psychology.

Chairman Burns remarked that Government plans to seek a court-ordered breakup of International Business Machines had been in the wind during the past week and might have been a market factor. He then asked whether the present policies and rulings of the Price Commission were beginning to have a more widespread effect on profits, as some business analysts had suggested.

Mr. Partee replied that the number of companies affected by the profit-margin ceiling would tend to grow over next winter and spring if the Price Commission's present regulations were not changed, on the assumption that margins generally would be moving upward with growing sales volume. So far, however, the main restriction growing out of the regulations appeared to have been on the pricing of 1973 automobiles. The auto industry's problem had been in the news more than a month ago; hence it could hardly have triggered the drop in stock prices of the last 4 days.

Mr. Bucher commented that to a lot of investment analysts IBM is a major factor in the stock market. Consequently, news of the Government's prospective move against the company might well have had a major influence on institutional investors.

Mr. Mitchell inquired about the effect that some disenchantment with the stock market might have on the demand for bonds and on interest rates. He thought the inflation component in interest

rates had not eroded very much so far, and he questioned whether it would now erode to a greater extent in conjunction with the behavior of the stock market.

In reply, Mr. Partee observed that, in part because individual investors had become disenchanted with the stock market, inflows of savings to financial institutions have been very high this year. If large institutional investors generally were now to become convinced that the rate of inflation was going to remain moderate for an extended period--which did not yet seem to be the case--the effect on demands for bonds versus those for equities could be fairly marked. Thus, the inflation component in interest rates might be reduced.

Mr. Daane noted that in his statement Mr. Axilrod had seemed to attach only minor importance to even keel considerations in the period before the next meeting. He asked for Mr. Holmes' view of the implications of Treasury financing for System operations.

Mr. Holmes replied that the Treasury had not yet decided on the nature of its November financing. The importance of even keel considerations would depend partly on the size of the financing and partly on other factors. Thus, if the Treasury used an auction technique and confined the financing to relatively short-term issues, even keel would be less important than otherwise. On balance, while account would have to be taken of the financing, there might be some leeway for a rise in interest rates if that should be implied by the Committee's policy decision today.

Chairman Burns observed that, according to a ticker report, the Dow Jones industrial average of common stock prices had risen more than 3 points by 11:30 this morning and that, as usual, the rise was being attributed to a variety of influences. He then asked what the consequences would be if the Congress failed before adjournment to extend the temporary increase in the debt ceiling beyond its scheduled expiration date of October 31 and then did not reconvene until after the November 7 elections.

Mr. Axilrod replied that before the October 31 expiration, the Treasury presumably would borrow as much as it could from the market and would borrow $5 billion--the legal maximum amount--directly from the System. In addition, the System and the Treasury would have to implement the contingency plans worked out last June when expiration of the higher debt ceiling also had been a possibility.

Mr. Holmes added that when Congress adjourned the Treasury might find that there was insufficient time before the ceiling expired to sell securities in the market. The Treasury might nevertheless still be able to arrange some borrowings directly from banks.

In reply to a question from the Chairman, Mr. Holmes observed that if the Treasury limited its borrowings to $5 billion

from the System, it would be in difficulty by about November 8. The Treasury faced a large cash drain in early November; and because it would not be able to issue new debt after October 31, it would not be able to deliver the bills scheduled for auction on Monday, October 30. Thus, about $4 billion would be drained off by net maturities of bills on Thursday, November 2.

Mr. Brimmer asked whether the staff had any advance information on the new price and wage guidelines to be instituted for the period after November 14. Also, he noted that all three drafts of the operational paragraph of the directive contained a reference to "possible bank regulatory changes." He had assumed that, in view of the current litigation, the System would not be able to implement the proposed changes in Regulations D and J before the next meeting.

In reply, Mr. Partee said the staff had thought it might prove possible to implement the bank regulatory changes in the period immediately ahead. The analysis in the blue book, however, had not taken specific account of that possibility. With respect to the wage and price guidelines, he had no information on the future of the program. There were two issues. First, the existing wage guidelines would expire on November 14, and the term-limit pricing agreements arranged with individual companies would begin to expire after that date. The program as presently constituted might merely be

extended for a period of time, or new guidelines and regulations might be promulgated. Secondly, the Administration had to determine whether to seek extension of the authorizing legislation that was scheduled to expire next April 30. To his knowledge, decisions had not been made with respect to either issue. However, there appeared to be wide support for continuation of the controls program in both Government and the business community.

Chairman Burns remarked that at present no one could be certain about the future of price and wage controls. In his judgment, however, it was likely that the Administration would request extension of the legislative authority for controls and that the Congress would respond favorably. And while he believed that changes would be made in the specific provisions of the program, they were not likely to be made as early as November 15; such a date would not allow sufficient time for deliberation, since active discussions probably would not get under way until after the elections. Although the character of the changes could not be predicted at present, he expected the program to remain relatively effective.

Mr. Heflin observed that he was concerned about the stickiness of the unemployment rate, which reflected at least in part an unusually rapid growth in the labor force. According to the green book, all of the recent gains in the labor force and

employment had been among part-time workers. He inquired whether that trend was of recent origin; whether it was likely to continue; and, if it continued, whether there would be any implications for what might be considered an acceptable rate of unemployment.

Mr. Partee replied that a large increase in the number of part-time workers had appeared in just the last few months and probably was a statistical aberration. Concerning the interpretation of the unemployment rate, the staff presently was engaged in a study of labor pressures during past periods relative to what might be significant in the future and would offer its conclusions in the chart presentation planned for the Committee's November meeting.

Mr. Wernick added that the household survey data had indicated large increases in part-time workers in the last 2 months. However, the establishment data indicated employment increases among manufacturing industries where ordinarily most workers were hired on a full-time basis.

Mr. Heflin then remarked that he had had difficulty in reconciling the projections in the blue book with those in the green book. For the current quarter the latter indicated an 8 per cent rate of growth in real GNP, sharp increases in both business and Treasury borrowing, and a swing in the high employment budget to a deficit of nearly $19 billion from a surplus of

\$4 billion in the third quarter. The blue book seemed to imply that, even in the face of such changes, money market conditions could be kept substantially unchanged without risking any acceleration in growth of the aggregates. As a matter of fact, under the specifications of alternative A--which included a range for the Federal funds rate centered on the prevailing level--growth in M_1 would be less rapid in the fourth quarter than in the third.

In response, Mr. Axilrod said he thought the projections in the green book and the blue book were generally consistent. The GNP projections in the green book were based on an assumption of growth in M_1 at a rate of 8 per cent in the second half of 1972--which implied a rate of about 7 per cent in the fourth quarter--and a rate of 6 per cent thereafter. The blue book, under alternative A, suggested that a 7 per cent rate of growth in M_1 over the fourth and first quarters would be accompanied by little change in money market conditions over the next couple of months. However, the blue book also suggested that, over the longer run, the funds rate and other short-term rates would begin to rise significantly, partly as sizable Treasury financings in December, January, and February intensified market pressures. It was expected that by the end of the first quarter--in the absence of a legislated ceiling on Federal expenditures--the rate on 3-month Treasury bills would rise more than 50 basis points into a range of 5-1/2 to 5-3/4 per cent.

Mr. Francis asked whether the statistics on unemployed resources overstated the economy's capacity for further economic expansion. In the St. Louis District, businessmen from widely separated regions had indicated that finding workers was becoming a major problem.

Mr. Partee replied that he had noted similar comments in several of the regional reports in the red book but that in each case the labor in short supply was qualified by some such word as "good" or "skilled." It was in the nature of an economic expansion that during the course of the upswing employers had to lower their standards in hiring workers, and the comments from businessmen probably reflected that need.

Mr. Francis remarked that some businessmen had said they could not find skilled or good workers, particularly in St. Louis where the unemployment rate had been higher than elsewhere in the District. Others, however, had complained about the scarcity of common labor. In Arkansas, for example, a company that had needed 100 unskilled workers had been able to hire only four.

Mr. Hayes commented that New York provided a classic example of a market where for years a high rate of unemployment had existed simultaneously with a shortage of qualified workers.

Mr. Brimmer observed that the red book report for the St. Louis District referred to "qualified labor" and "good labor."

However, unemployed workers who were less qualified still had some qualifications to offer and represented an available resource.

Chairman Burns commented that interpretation of statistics on the unemployment rate was a continuing problem. Increasingly, the figures reflected voluntary rather than involuntary unemployment. Full employment had always meant that workers with few qualifications would have the opportunity for relatively well-paying jobs, and production would be subject to a certain level of inefficiency. Although the whole problem was important, the Committee could not make much progress with it today.

Mr. Francis remarked that he was concerned about an additional problem--one growing out of the price control program. Many companies large enough to be subject to the controls obtained supplies from smaller companies that were not under the program. Consequently, the larger companies were experiencing increases in costs that they could not pass on in higher prices for their own products.

Mr. Eastburn observed that, as he understood it, the Committee had decided to experiment with an emphasis on RPD's in its operations because the data on reserves, which were available more promptly than data on the monetary aggregates, bore a close relationship to the latter. That conclusion was supported by an analysis at the Philadelphia Bank, in which it was found that

estimating errors in RPD's in recent months had been accompanied by estimating errors in the aggregates in the same direction. Against that background, he questioned whether the following statement in the blue book was consistent with the Committee's experiment: ". . . if the monetary aggregates appear to be remaining within the Committee's targeted range, the Manager would not have to take any reserve action that tightens or eases the money market, even though RPD is running high or low in its range."

In reply, Mr. Axilrod said he did not think that the statement was inconsistent with the Committee's experiment. The blue book also said, parenthetically: "Under such circumstances, it would be presumed that unanticipated changes in the multiplier relationship between reserves and monetary aggregates had occurred." In the staff's judgment, the Committee would want to accommodate increases in demands for reserves if, as had been the case a few months ago, they reflected a rise in deposits of city banks relative to those of country banks or a gain in excess reserves. Such changes affecting the multiplier between reserves and deposits might be frequent in the short run, but the longer-run relationship between RPD's and the monetary aggregates should be more consistent. He believed that the Committee had decided to emphasize RPD's as an operating handle because they bore a more consistent relationship

to the aggregates than did money market conditions, but that it would want unanticipated shifts in the multiplier relationship to be taken into account.

Mr. Mitchell observed that detailed data on excess reserves and on reserves required for private demand deposits, CD's, and other time deposits offered some support for Mr. Axilrod's observations. In a few cases, disturbances had come from variations in excess reserves. Reserves against private demand deposits had declined somewhat since April, while reserves against CD's had increased substantially. The relationship between RPD's and private demand deposits was rather tenuous; the proportion of RPD's held against private demand deposits did vary significantly.

Mr. Eastburn remarked that he would think the Committee should accommodate such short-term variations.

Mr. Axilrod agreed. He added that one point at issue was the relationship between the funds rate constraint and the reserve target. If the Committee did not wish to permit short-run adjustments of the RPD target as the multiplier shifted, on the thought that over the longer run the multiplier would be more stable, it probably would have to widen the funds rate constraint.

Mr. Mitchell asked whether an increase in excess reserves in one period tended to be transformed into growth in private demand deposits in a later period. It appeared to him that large excess reserves in June had led to a large increase in demand

deposits in July, and he noted that excess reserves were again large in the latest 2 weeks.

Mr. Axilrod replied that more recently excess reserves had declined again. Over the past month or two, however, bank demands for excess reserves had been surprisingly large and also less stable than anticipated. No doubt the uncertainties related to the impact of the planned changes in Regulations D and J had been one factor. But high excess reserves would not, of course, lead to a large expansion in deposits unless the demand for such reserves dropped and the System did not adjust its operations to take account of the drop. A downward shift in demands could lead to an undesired expansion in deposits if it were not anticipated in setting reserve targets or if there were not sufficient flexibility for open market operations to take it into account.

Mr. Coldwell remarked that, like Mr. Eastburn, he thought the discussion of policy alternatives in the blue book represented a change from the Committee's experiment. He had in mind the shift in focus from projections to targets and from quarterly rates of growth in the aggregates to monthly rates. Whether or not there had been a shift of focus, it seemed to him that the Committee needed to consider carefully the ranges it established for both the Federal funds rate and the aggregates, perhaps widening the range for the former and narrowing the ranges for the latter.

Chairman Burns observed that there had been a shift of focus. It had been made against the background of the discussion of the last meeting, in which he thought there had been some confusion between targets and projections. He planned to make a suggestion to the Committee shortly to help focus its policy discussion today.

Mr. Morris said that he had been impressed by the divergence between the Board and New York Bank projections of the monetary aggregates, particularly during the last month when the New York projections had been closer to the mark. He raised the question of whether the divergence reflected differences in view on appropriate seasonal adjustment factors.

Mr. Holmes replied that while judgments differed regarding the quality of the factors employed, the same factors were used at the Board and the New York Bank.

Chairman Burns said he would like to offer some general reflections on Committee procedures at this point. He thought that the Committee's deliberations had suffered from continual confusion between targets on the one hand and projections on the other. As a policy-making body, the Committee's main responsibilities were to set targets and to issue specific operating instructions to the Desk. The members' views on appropriate policy necessarily reflected their judgments about the economic outlook, and the Desk necessarily employed projections in making operating decisions. Thus, forecasts and projections were and would remain a part of the over-all process. However, he did not believe it

was desirable for the Committee to engage in lengthy discussions of projection procedures or of the relative merits of the projections made at the Board and the New York Bank. While members who were interested in such technical questions were, of course, free to pursue them individually with the staff, he thought the Committee as a whole should concern itself primarily with targets and instructions.

Partly in the interest of time and partly to focus the discussion, the Chairman continued, he would suggest certain targets and operating instructions for consideration by the Committee. He proposed that targets be specified in terms of desired annual rates of growth for monetary aggregates over the next 6 months. Specifically, he suggested that the members consider the following targets for growth rates over the fourth and first quarters combined: M_1, 6 per cent; M_2, 7 per cent; and the bank credit proxy, 7 per cent. It would be recognized, of course, that the Committee might decide to adopt different targets at its next meeting or at any subsequent meeting.

As to instructions to the Desk, Chairman Burns suggested that the Committee specify ranges of tolerance for annual rates of growth over the October-November period in RPD's, M_1, and M_2, and a range of tolerance for the daily-average Federal funds rate for statement weeks in the period until the next meeting. There always was a risk of inconsistency in such instructions, but that risk could be dealt with by means similar to those employed in the

past. Specifically, if it appeared that significant inconsistencies were developing, the Manager would promptly notify the Chairman, who would then promptly decide whether the situation called for special Committee action to give supplementary instructions.

For RPD's, Chairman Burns proposed a range of tolerance of 6-1/2 to 11-1/2 per cent. If that were the only constraint, it might be interpreted in the following manner: so long as the rate of growth in RPD's over the October-November period appeared to be within the range, the Desk would seek to maintain the Federal funds rate in the general neighborhood of the prevailing level, which he understood was a shade over 5 per cent. If it appeared, however, that RPD growth was exceeding 11-1/2 per cent, the Desk would aim at somewhat greater restraint; and if it appeared that RPD growth was below 6-1/2 per cent, the Desk would move toward somewhat greater ease. For M_1 and M_2, he suggested ranges of tolerance of 3-1/2 to 6-1/2 per cent and 5 to 8 per cent, respectively, to be interpreted in the same way. Finally, for the Federal funds rate he suggested a range of tolerance of 4-3/4 to 5-1/2 per cent. Any significant inconsistencies that arose would be dealt with in the manner he had mentioned.

While those suggestions were offered only as a basis for discussion, the Chairman continued, it might be helpful to indicate some of the reasoning that went into their formulation.

In particular, it was worth noting that the short-run range of tolerance he proposed for M_1--3-1/2 to 6-1/2 per cent--was not symmetrical around the suggested longer-run target for that variable of 6 per cent. Such asymmetry seemed desirable because monetary growth rates had recently been on the high side. Similarly, the proposed range for the Federal funds rate was not symmetrical around the existing rate. A wider range for the funds rate could be employed; indeed, the Committee could specify the range of 4-3/4 to 6 per cent shown under alternative B in the blue book. In his judgment, however, it would be unrealistic to set a 6 per cent upper limit for the funds rate at present. Although conditions might well develop which would lead to a different view, he doubted that the Committee was prepared at this time to tolerate a one percentage point rise in the funds rate.

As he had indicated, the Chairman said, he hoped those suggestions would help provide a focus for the Committee's discussion. He then called for comments on monetary policy and the directive, beginning with Mr. Hayes.

Mr. Hayes observed that the New York Bank staff's assessment of the economic outlook was quite similar to that of the Board's staff. He agreed that recent wage-price developments had been encouraging. More time would be needed before one could

be confident that an improvement had occurred in the trend of wholesale industrial prices, but there certainly were grounds for hope in that area. As he looked ahead, he was concerned about the implications of the narrowing margin of unused resources and about the outcome of the new round of wage negotiations, and he certainly hoped that the wage-price control program would be retained and strengthened. With respect to fiscal policy, it was obviously of great importance that the proposal for an expenditure ceiling currently under discussion in Congress be enacted.

In his judgment, Mr. Hayes continued, the setting for the Committee's policy decision seemed a bit more favorable today than it had a month ago in view of the recent growth in the money supply, which was appreciably slower than had seemed likely then, and the possibility, at least, of a better outlook for the budget. However, the basic reasons for maintaining a fairly firm monetary stance remained unchanged--namely, the very strong economic outlook, the existence of some doubts about the future of the wage-price control program, the fragile international situation, the fact that inflationary expectations had not been completely eradicated, and the excessive growth in the monetary aggregates over the past quarter and the year to date.

With respect to longer-run targets for money and credit expansion, Mr. Hayes said he would prefer growth rates symbolized by a 5 to 5-1/2 per cent rate for M_1; such rates, in his judgment, would make adequate allowance for the kind of velocity increases that might accompany a strong business expansion. As to short-run ranges of tolerance for RPD's and the aggregates, those suggested by the Chairman seemed quite reasonable. For the Federal funds rate, he would lean toward a range of 5 to 5-1/2 per cent; on the one hand, he would like to keep money market conditions as firm as they were now, and on the other hand, he recognized that caution was indicated by the forthcoming Treasury financing as well as other factors.

Mr. Hayes then said it was not wholly clear to him how the Manager would be expected to operate if he were given short-run constraints of the kind the Chairman had described. The ranges mentioned for growth rates in RPD's and the monetary aggregates, and for the Federal funds rate, were relatively wide, and he was a little puzzled as to what objectives the Manager would pursue in, say, tomorrow's operations.

Chairman Burns remarked that it might be helpful to have the Manager set forth his own understanding on that question.

Mr. Holmes said he would interpret the instructions as calling for keeping the funds rate at about its present level at

the outset of the period. New data on RPD's would become available from time to time, and on Friday--when another week's data for the monetary aggregates were in hand--it would be possible to begin formulating judgments as to whether the projections of the Board's staff or the lower projections of the New York Bank were closer to the mark. If those judgments suggested that the aggregates were growing undesirably fast, the Desk would begin to seek moderately higher funds rates. He would propose not to take such action on the basis of new data for a single week, but to wait for confirmation from another week's figures.

Chairman Burns asked whether the Manager had any question about the proposed interpretation of the ranges of tolerance for RPD's and the monetary aggregates.

Mr. Holmes said he did not; in general, the objective was to tolerate larger deviations from the longer-run targets for the aggregates on the downside than on the upside. He added that the course the Chairman proposed--of maintaining prevailing money market conditions so long as the growth rates appeared to fall anywhere within their ranges of tolerance--would represent a slight change from customary practice. In the past the Desk had not waited until growth rates appeared to be moving outside the desired ranges before making any modification whatsoever in prevailing money market conditions; rather, it had begun to shade the funds

rate in the appropriate direction when the growth rate began to approach one limit or the other of the specified range. He thought there was much to be said for that practice, so long as the shading was quite gradual.

Chairman Burns noted that the course he proposed had the advantage of simplicity. On the other hand, it was admittedly a rather mechanical procedure, offering little room for the exercise of discretion by the Desk. On balance, he would not object to some shading of the funds rate if the aggregate growth rates appeared to be close to the upper or lower limits. However, more vigorous action should be taken only if the growth rates appeared to be outside the range.

Mr. Mitchell said he thought the Chairman's proposals involved the problem of overspecification. It was not clear to him what the Manager would do if, for example, M_1 and the Federal funds rate were both within their respective ranges but M_2 was outside its range.

Chairman Burns remarked that the Committee had customarily engaged in overspecification in setting its various targets and constraints. It was in recognition of that fact that the Manager had been instructed under the procedures adopted in February to consult with the Chairman if significant inconsistencies appeared to be emerging. One reason for overspecification was that the

members differed in the relative emphasis they preferred to place on different types of targets. The Committee as a whole had never decided to follow either the monetarist route or the money market route to the exclusion of the other. It had decided to place greater emphasis on monetary aggregates than in the past, but it had also agreed not to ignore interest rates.

Mr. Robertson said he concurred in the ranges of tolerance the Chairman had proposed for short-run operating constraints. As to the longer-run targets, he noted that the Chairman had suggested figures for M_1, M_2, and the bank credit proxy. He would favor adding RPD's to that list; indeed, he would go further and make RPD's the main target.

Chairman Burns remarked that the target growth rate for RPD's consistent with the rates he had proposed for the monetary aggregates could be estimated readily from the data shown in the blue book. As he interpreted the figures, that RPD growth rate would be 7 per cent.

Mr. Hayes noted that the proposed ranges of tolerance for RPD's and the aggregates applied to the 2 months of October and November. It appeared, therefore, that the Desk would have to employ projections, at least for November, in making operating decisions during the period until the next meeting.

Chairman Burns agreed. While he thought that special emphasis should be placed on what was already known, it was clear that the Desk and the Board's staff would have to continue to work with projections, fallible though they were. In his earlier comments he had meant to suggest that the Committee itself should not confuse its policy discussions with debates on projections. Although the members as individuals would still be concerned with projections, the main concern of the Committee was with targets. There would be differences of view about targets--today, for example, he had suggested seeking a longer-run growth rate for M_1 of 6 per cent, and Mr. Hayes had expressed a preference for a rate of 5 to 5-1/2 per cent--which the Committee should debate. The Committee also had to give some attention to operating constraints, but even there he hoped it would not attempt to do the Manager's job by specifying constraints in such detail that the latter was left with no room for judgment.

Mr. Mitchell said he would like to return to the subject of overspecification. His concern was not with potential inconsistencies between the objectives for some aggregate and for interest rates; he recognized that the Committee might often want to limit the range of fluctuation in the Federal funds rate even though that could preclude the attainment of its objective for an aggregate. What concerned him was the potential inconsistency between

targets for the different aggregates. He did not think any useful purpose was served by specifying separate targets for M_1, M_2, and the bank credit proxy, since inconsistencies would almost inevitably develop. Indeed, he thought the Committee had decided last February to use RPD's for operating purposes in order to deal with that problem.

The Chairman said it was his recollection that the Committee had decided to put primary emphasis on RPD's, but also to instruct the Desk to pay some attention to the monetary aggregates in interpreting the changes in RPD's.

Mr. Mitchell remarked that that was his recollection also.

Chairman Burns said he was inclined to agree with Mr. Mitchell that it would be undesirable, and inconsistent with the Committee's recent practice, to place the operating constraints for RPD's, M_1, and M_2 on an equal footing. Instead, the Desk should put main emphasis on the constraint for RPD's, while giving attention to the other aggregates. He would also suggest that the Desk be instructed, in interpreting movements in RPD's, to make appropriate allowance for unanticipated changes in the reserve-deposit multiplier.

Mr. Brimmer remarked that over recent years the Committee had been struggling to develop a systematic procedure for formulating policy, and only this February--after considering the

report of the Maisel committee on the directive--it had agreed to experiment with a specific procedure. Against that background, he was distressed by the proposals the Chairman had made today. As he understood those proposals, they appeared to involve some fundamental changes in procedure; and they had been offered on short notice, without adequate opportunity for full consideration. Among other things, he was disturbed by the suggestion that the Committee adopt targets not just for the period until the next meeting but for 6 months ahead.

Chairman Burns said he had set forth specific proposals at the outset of the policy discussion because the time available for that discussion was so limited. In proposing certain 6-month targets for the aggregates, he had not meant to suggest or imply a long-run commitment; any targets approved today would be subject to change at subsequent meetings. And the operating constraints he had mentioned were intended to govern operations only for the period until the next meeting.

The Chairman went on to note that in June, as the members would recall, the Committee had met over a 2-day period in order to provide adequate time for a thorough discussion of a chart presentation on the economic outlook. He had intended to suggest that in November, when the staff would be making its next chart presentation, the Committee again hold an extended meeting,

beginning on the afternoon of Monday, November 20, for the same purpose. He would now suggest that at its November 20 session the Committee consider not only the economic outlook but also its policy-making procedures, insofar as any new questions on that score had been raised today.

There was general agreement with the Chairman's suggestion.

Mr. Mitchell observed that he did not consider the procedures implied by the Chairman's proposals to be greatly different from those the Committee had been following recently.

Mr. Daane said he welcomed the Chairman's emphasis on targets for the aggregates, as distinct from projections, particularly considering the state of the projection art. And he welcomed the use of a 6-month time span for formulating the aggregate targets. In his judgment such a longer-run framework was much to be preferred to a focus on week-to-week fluctuations.

However, Mr. Daane continued, he thought the Committee's consensus on targets should not be confined to the aggregates; it should also include some indication of the members' preferences for the level and direction of change of interest rates. As the Chairman had indicated, the Committee had decided that it could not ignore interest rates; and while it need not attempt to pinpoint its objectives for rates, it should not limit itself to

specifying a short-run operating constraint for the funds rate. According to the blue book, the funds rate constraints suggested there could be modified by the Committee, "depending upon how much emphasis it wants to place on limiting possible variations in interest rates, the degree to which it wishes to stress growth rates for the aggregates, and the extent to which it wants to take account of special circumstances of the moment such as even keel." He would generalize that statement to apply not just to the constraint for the funds rate but to all of the policy ranges covered by the Chairman's proposals.

Personally, Mr. Daane observed, for a variety of reasons he was more sensitive at the moment to interest rates than to the aggregates. He could accept the range for the Federal funds rate the Chairman had suggested, although he might prefer to modify it a bit; and he liked the notion of specifying short-run constraints for aggregate growth rates in terms of relatively wide ranges. As to even keel considerations, he had not found persuasive the comments by Messrs. Axilrod and Holmes on that subject and would want to put more stress on such considerations than they had suggested.

Finally, Mr. Daane remarked, as a nonmonetarist he certainly would react negatively to any proposal for a commitment to particular growth rates for the aggregates. However, he did not view the aggregate targets suggested by the Chairman as involving such a commitment.

Mr. Brimmer said he did not object to setting targets for the aggregates; the Committee had been doing so for some time. As he had indicated, however, he was concerned about the proposal that the Committee adopt 6-month targets at today's meeting. Also, he was disturbed by the suggestion that the Committee not discuss projections. The distinction between desired and expected outcomes was an important one, and projections were needed to provide information on expected outcomes.

Chairman Burns expressed the view that the key question concerned actual outcomes--that is, whether the Committee's targets were being achieved.

After further discussion, Mr. Robertson said he thought it might help clarify the issue to note that the targets for the aggregates proposed by the Chairman were those shown under alternative B in the blue book. The proposed operating constraints differed somewhat from those associated with B--the lower limit of the range for each of the aggregates had been reduced by one or two percentage points, and the upper limit of the range for the funds rate had been moved down from 6 to 5-1/2 per cent--but even after those modifications, the specifications could be encompassed by the language of alternative B. In his judgment the members could vote for or against alternative B, with the proposed modifications in specifications, without feeling that they were departing in any significant sense from past procedures.

Mr. Mitchell remarked that ranges of tolerance proposed for RPD's and the monetary aggregates would seem more appropriate when applied to growth over periods of 3 or 6 months than to growth in a short period. Because of the volatility of the series, the limits of such ranges were quite likely to be breached in a short period, and such an outcome would not necessarily have significant economic consequences. In his judgment, the real thrust of the proposed policy course lay in the 4-3/4 to 5-1/2 per cent range for the Federal funds rate; if the funds rate broke through 5-1/2 per cent, there would be a whole new ball game.

Mr. Robertson observed that the upper limit of the range set for the funds rate would not be breached. As he understood it, the Desk would focus first on the growth rate of RPD's, and it would take the funds rate into account only if that rate began to approach one of the limits of its range. If the funds rate came under upward pressure, the Desk would supply the reserves needed to prevent it from exceeding 5-1/2 per cent, even though that meant faster growth in RPD's.

Mr. Daane commented that, as he had indicated earlier, he would want to put main stress on interest rates. He personally would like to see rates stay about where they were.

Mr. Hayes said he would agree that it was more important to keep the Federal funds rate from moving outside whatever range

was set for it than to hold the aggregates within their specified ranges.

Chairman Burns said it should be made clear that the range for the funds rate was to be interpreted in terms of daily averages for statement weeks and not day-to-day levels.

Mr. Daane asked the Manager how he assessed the proposed 4-3/4 to 5-1/2 per cent range for the Federal funds rate. Was it sufficiently wide? Was it perhaps too wide, considering the impending Treasury financing?

Mr. Holmes replied that the range seemed ample to him. He assumed that the Committee would not want the funds rate to rise to the upper limit at a time when even keel considerations were important.

Mr. Daane expressed the view that even keel considerations would be important for much of the coming period. He considered the 6 per cent upper limit for the funds rate shown under alternative B in the blue book to be inconsistent with even keel, and he had some question about the 5-1/2 per cent upper limit the Chairman had proposed.

Chairman Burns remarked that he had suggested reducing the upper limit for the funds rate from 6 to 5-1/2 per cent because he thought the former figure was unrealistic. In his judgment, however, the Committee should not attempt to reflect even keel considerations

in the range it established for the funds rate; all of the proposed operational paragraphs included instructions to take account of Treasury financing activity as well as other factors, and the Manager's operations would be governed by such instructions. He doubted that it would be desirable for the Committee to spell out the precise degree to which Treasury financing should influence operations.

Mr. Hayes agreed that it was appropriate to give the Manager a certain amount of discretion with respect to even keel and other special factors.

Mr. MacLaury remarked that he had found the Chairman's general proposal to be quite helpful. He thought the confusion about Committee procedures that had emerged explicitly today had been implicit in earlier discussions, and accordingly he welcomed the plan to review procedures at the November meeting. As to the specific operating constraints suggested, there was some question in his mind whether the 6-1/2 to 11-1/2 per cent range for the October-November growth rate in RPD's was consistent with the ranges of 3-1/2 to 6-1/2 per cent for M_1 and 5 to 8 per cent for M_2.

Mr. Hayes said it was his impression that a somewhat lower range for RPD's would be consistent with the proposed ranges for the monetary aggregates.

In response to a question, Mr. Axilrod noted that the ranges in question were modifications of those shown in the blue book under alternative B. In the staff's judgment the midpoint of the blue book range for RPD's was likely to prove consistent with those for the monetary aggregates in the alternatives specified there. Since the suggested modifications consisted of reducing the lower limits of all three ranges somewhat--by one percentage point for RPD's and two percentage points for M_1 and M_2--he thought the midpoints would still be generally consistent.

Mr. Robertson suggested that the short-run operating constraint for RPD's be made symmetrical around the longer-run target for that variable.

Chairman Burns commented that he would not consider such symmetry to be an objective. However, the Committee might prefer to set the lower limit of the RPD constraint at 6 rather than 6-1/2 per cent, and perhaps also to reduce the upper limit slightly.

After discussion it was agreed that the operating constraint for the growth rate of RPD's should be 6 to 11 per cent.

Mr. Eastburn asked whether the Manager would be expected to edge the funds rate upward if RPD's appeared to be growing at a rate of, say, 9 or 10 per cent.

Chairman Burns replied that such a procedure had not been contemplated under his original proposals. However, he was inclined

to agree with the Manager's suggestion that the funds rate should be shaded up or down if the growth rate of RPD's appeared to be approaching the upper or lower limit of the specified range. The Desk would, of course, react with greater vigor if RPD growth appeared to be outside the range.

Mr. Eastburn then asked the Manager to indicate just how he would propose to proceed in shading operations if the RPD growth rate was near the upper limit.

In reply, Mr. Holmes said his first step would be to determine whether the RPD growth rate was high only because the reserve-deposit multiplier was behaving in an unexpected fashion. If that proved to be the explanation, the Desk would not react at all. If RPD's were running high for more meaningful reasons, and if the monetary aggregates also appeared to be high, the Desk would seek to increase the weekly average funds rate slightly--by no more than one-eighth of a percentage point. In general, he thought it was desirable to proceed in a very gradual fashion; if the Desk reacted strongly to one week's data on RPD's and the aggregates, it was likely to find it necessary to reverse course when the next week's data were received.

In reply to a question by Mr. Robertson, Mr. Holmes said the Desk's primary emphasis would be on the growth rate in RPD's. Under the specifications the Committee was discussing, the Desk

would aim at a growth rate for RPD's in the October-November period of 8-1/2 per cent, the midpoint of the 6 to 11 per cent range.

Mr. Mitchell remarked that, as he had indicated earlier, RPD's and the monetary aggregates were volatile in the short run. Accordingly, he would not want the Desk to rely heavily on the apparent growth rate in RPD's in making day-to-day operating decisions.

Mr. Daane observed that while he was agreeable to setting a target for RPD growth over the longer run, like Mr. Mitchell he thought the Desk should not aim at some pinpointed RPD target in the short run.

Mr. Brimmer indicated that he would not favor setting longer-run targets at today's meeting. He noted that he had favored having the Committee make broad decisions on the longer-run course of policy a few times each year, in connection with thorough reviews of the economic outlook. He thought the November meeting would be an appropriate occasion to consider objectives for the longer run, since the staff would be presenting a chart show on the outlook at that meeting.

The Chairman suggested that, since it was not essential for operating purposes that the Committee set longer-run targets today, no formal vote on such targets be taken. At the same time, he thought it would be useful to arrive at some sense of the Committee's thinking on the matter. He asked whether the members believed that the annual rates of growth for the fourth and first quarters combined which he had mentioned earlier--7 per cent for RPD's, 6 per cent for M_1, and 7 per cent for M_2 and the bank credit proxy--would be reasonable as targets, recognizing that any such targets would be subject to careful review at the next meeting and to reconsideration at each subsequent meeting.

After discussion, the Chairman noted that it was the sentiment of the majority that such growth rates would represent reasonable targets. He then proposed that the Committee vote on a directive consisting of the staff's draft of the three general paragraphs and alternative B of the operational paragraph. It would be understood that that directive would be interpreted in the manner discussed earlier. In particular, the following ranges of tolerance would be employed as short-run operating constraints: average annual rates of growth for the October-November period, 6 to 11 per cent for RPD's, 3-1/2 to 6-1/2 per cent for M_1, and 5 to 8 per cent for M_2; and daily-average Federal funds rates for statement weeks in the period until the next meeting, 4-3/4 to 5-1/2 per cent.

Mr. Axilrod said it might be worth noting that at present the Board's staff's best estimate of the growth rate of RPD's in the October-November period under prevailing money market conditions was 10-1/2 per cent. He assumed that the Manager would also be taking account of the New York Bank's projection, which was lower.

Chairman Burns observed that if the Manager should conclude that RPD's were growing at a rate of 10-1/2 per cent he would be authorized to aim for a slightly higher funds rate.

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

The information reviewed at this meeting suggests a substantial increase in real output of goods and services in the third quarter, although well below the unusually large rise recorded in the second quarter. In September wages and prices advanced moderately, while the unemployment rate remained substantial. In the U.S. balance of payments, the current account deficit has been largely offset by capital inflows in recent weeks, and the central bank reserves of most industrial countries have continued to change little. In August, the excess of U.S. merchandise imports over exports declined somewhat.

The narrowly and broadly defined money stock expanded at moderate rates in August and September, following large increases in July, but the bank credit proxy continued to grow rapidly. Since mid-September, short-term interest rates have increased somewhat, while yields on most long-term securities have changed little.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, while taking account of the effects of possible bank regulatory changes, Treasury financing operations, and developments in credit markets, the Committee seeks to achieve bank reserve and money market conditions that will support more moderate growth in monetary aggregates over the months ahead than recorded in the third quarter.

Secretary's note: The specifications agreed upon by the Committee, in the form distributed following the meeting, are appended to this memorandum as Attachment B. In materials distributed subsequently the range of tolerance for RPD growth was modified to 9 to 14 per cent. This was a technical adjustment to allow for the effects of the Board's decision on October 24, 1972, to implement as of November 9, 1972, the changes in Regulations D and J that had originally been scheduled to take effect earlier but had been delayed as a result of court proceedings.

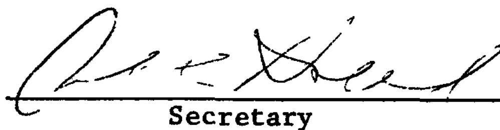
It was agreed that the next meeting of the Federal Open Market Committee would be held on Monday and Tuesday, November 20-21, 1972.

Mr. Daane suggested that the Committee consider holding all of its meetings over a 2-day period, beginning on Monday afternoons and continuing the following mornings.

Chairman Burns remarked that such a plan was worth consideration. One possibility, on which he would appreciate having the

members' views, would be for the Committee to hold periodic dinner meetings--perhaps 4 to 6 times a year--on the Mondays before the regular Tuesday morning sessions.

Thereupon the meeting adjourned.



Secretary

ATTACHMENT A

CONFIDENTIAL (FR)

October 16, 1972

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on October 17, 1972

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests a substantial increase in real output of goods and services in the third quarter, although well below the unusually large rise recorded in the second quarter. In September wages and prices advanced moderately, while the unemployment rate remained substantial. In the U.S. balance of payments, the current account deficit has been largely offset by capital inflows in recent weeks, and the central bank reserves of most industrial countries have continued to change little. In August, the excess of U.S. merchandise imports over exports declined somewhat.

The narrowly and broadly defined money stock expanded at moderate rates in August and September, following large increases in July, but the bank credit proxy continued to grow rapidly. Since mid-September, short-term interest rates have increased somewhat, while yields on most long-term securities have changed little.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPHS

Alternative A

To implement this policy, while taking account of the effects of possible bank regulatory changes, Treasury financing operations, and developments in credit markets, the Committee seeks to achieve bank reserve and money market conditions that will support somewhat more moderate growth in monetary aggregates over the months ahead than recorded in the third quarter.

Alternative B

To implement this policy, while taking account of the effects of possible bank regulatory changes, Treasury financing operations, and developments in credit markets, the Committee seeks to achieve bank reserve and money market conditions that will support more moderate growth in monetary aggregates over the months ahead than recorded in the third quarter.

Alternative C

To implement this policy, while taking account of the effects of possible bank regulatory changes, Treasury financing operations, and developments in credit markets, the Committee seeks to achieve bank reserve and money market conditions that will support moderate growth in monetary aggregates over the months ahead.

ATTACHMENT B

STRICTLY CONFIDENTIAL (FR)

October 17, 1972

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 10/17/72)
A. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (October-November average):		6 to 11% [1/]
2. Ranges of tolerance for monetary aggregates (October-November average):	M_1:	3-1/2 to 6-1/2%
	M_2:	5 to 8%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		4-3/4 to 5-1/2%
4. Federal funds rate to be moved in an orderly way within range of toleration		
5. Other considerations: account to be taken of the effects of possible bank regulatory changes, Treasury financing operations, and developments in credit markets.		

B. If it appears that the Committee's various operating constraints are proving to be significantly inconsistent in the period between meetings, the Manager is promptly to notify the Chairman, who will then promptly decide whether the situation calls for special Committee action to give supplementary instructions.

1/ Subsequently modified to a range of 9 to 14 per cent, to allow for the Board action of October 24, 1972, to implement changes in Regulations D and J effective November 9.

ATTACHMENT C

Mr. Daane's Statement on Bank-Fund Meeting

This year's annual meeting of the Governors of the Fund and Bank, held during the week of September 25-29, was a definite plus for the United States, despite some adverse publicity connected with a recent U.S. initiative related to the question of a third term for Pierre-Paul Schweitzer as Managing Director of the IMF. The most important single factor making the meeting so constructive and positive was the leadership role assumed by the United States, as reflected both in President Nixon's opening address and in Secretary Shultz's speech on the following day. In that speech the Secretary listed principles underlying monetary reform that already command widespread support, and went on to present a set of carefully-thought-out ideas relating to the fundamental issues and problems involved in international monetary reform.

The U.S. initiative was widely hailed by other speakers at the meetings. Even the French Minister of Finance, Valery Giscard d'Estaing, alluded to it favorably in his remarks, and was reported to have commented later that it had significantly changed the tone of the discussions.

So far as the Fund is concerned, the main task of this year's annual meeting was to complete the procedural organization

of the work on the major reform of the international monetary system that must be carried out within the next few years. Last July, the Fund Governors adopted a Resolution providing for the establishment of an ad hoc "Committee of the Board of Governors on Reform of the International Monetary System and Related Issues" (known as the Committee of Twenty). The Resolution provided that each member of the Committee shall appoint not more than two associates. Secretary Shultz is the U.S. member, and Chairman Burns and Under Secretary Volcker are his associates. The Resolution also provided for the establishment of a group to be known as the Deputies, to consist of not more than two members appointed by each member of the Committee. Paul Volcker and I are the U.S. Deputies.

The Resolution provided further that the Chairman of the Board of Governors of the Fund would convene the first meeting of the Committee, and preside over it until a Chairman had been selected. In accordance with this provision, the inaugural meeting of the Committee of Twenty was convened on September 28 by the Minister of Finance of Indonesia, Ali Wardhana, in his capacity as this year's Chairman of the Governors of the Fund. Mr. Wardhana was selected to serve as Chairman of the Committee, after which C. Jeremy Morse, an Executive Director of the Bank of England, was selected to serve as Chairman of the Deputies of the Committee.

The Deputies met on the following day, September 29, under the chairmanship of Mr. Morse. As you know, they selected

two Vice Chairmen: our own Bob Solomon, Adviser to the Board, and Alexandre Kafka of Brazil, an Executive Director of the Fund. Two additional Vice Chairmen, one from Japan and one from a developing country, may also be selected. The Deputies agreed to hold their next meeting in Washington on November 27-29, and to devote it entirely to the subject of the adjustment process which is recognized as the most important aspect of reform.

During the week of the Fund and Bank meetings the Group of Ten also met, at both the Ministerial and the Deputies level, and these meetings too were largely procedural. Valery Giscard d'Estaing succeeded to the chairmanship of the Ministerial group, and Rinaldo Ossola, Deputy General Manager of the Bank of Italy, became Chairman of the Deputies.