MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held on Wednesday, October 10, 1973, at 10:15 a.m., at the call of Chairman Burns, in order to consider further instructions to the Manager of the System Open Market Account for the period until the regularly scheduled October 16 meeting. This was a telephone conference meeting, and each individual was in Washington, D.C., except as otherwise indicated in parentheses in the following list of those participating:

PARTICIPATING: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman (New York)
Mr. Balles (San Francisco)
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis [1/] (Atlanta)
Mr. Holland
Mr. Mayo (Chicago)
Mr. Mitchell
Mr. Morris (Boston)
Mr. Sheehan

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

1/ Mr. Francis, President of the St. Louis Federal Reserve Bank, was visiting in Atlanta on the day of this meeting and participated in the conference from that city.

Mr. Sternlight, Deputy Manager,
System Open Market Account
(New York)

Mr. Melnicoff, Deputy Executive Director,
Board of Governors
Mr. Feldberg, Secretary to the Board
of Governors
Mr. Coyne, Assistant to the Board of
Governors
Messrs. Keir and Pierce, Advisers,
Division of Research and Statistics,
Board of Governors
Mr. Wendel, Chief, Government Finance
Section, Division of Research and
Statistics, Board of Governors
Miss Pruitt, Economist, Office of the
Secretary, Board of Governors
Mrs. Ferrell, Open Market Secretariat
Assistant, Office of the Secretary,
Board of Governors

Mr. Taylor, Senior Vice President,
Federal Reserve Bank of Atlanta (Atlanta)
Mr. Fousek, Economic Adviser, Federal
Reserve Bank of New York (New York)
Mr. Poole, Adviser, Federal Reserve Bank
of Boston (Boston)

Secretary's Note: On Tuesday, October 9, the Secretary had transmitted the following message to members of the Committee (to President-members by telegram):

"Since telephone meeting of October 2, monetary aggregates have shown further weakness, with RPD's for September-October now estimated at about 8 percentage points below bottom of FOMC's range of tolerance. Short-term market interest rates have declined further on balance. The Federal funds rate generally remained in a 10-5/8 to 10-3/4 per cent range last week despite large reserve-supplying operations. Today, however, the large cumulative reserve injection has led to a drop in the funds rate to around 8 per cent after it opened in a 9-3/4 - 10 per cent range.

"Against the background of these developments, Chairman Burns has called a telephone conference of the FOMC for 10:15 a.m., EDT, October 10, 1973, to consider further instructions to the Manager for the period until the regularly scheduled October 16 meeting.

"Possible alternative instructions for consideration follow:

"1. To continue to aim at an average Federal funds rate of about 10-1/2 per cent.

"2. To provide reserves at a rate considered likely to be consistent with a Federal funds rate averaging about 10-1/4 per cent between now and the regularly scheduled meeting.

"3. To provide reserves aggressively, in order to begin making up for recent substantial shortfalls in growth of RPD's and other monetary aggregates. The Federal funds rate would be expected to decline initially to an average of about 10-1/4 per cent, and to drop further to around 10 per cent should the recent weakness in the aggregates be confirmed by this week's new data.

"As will be noted, alternatives 2 and 3 contemplate a modest easing of money market conditions beyond that agreed to by the Committee on October 2. If either is adopted, the Committee may wish to consider whether or not the Desk should be instructed to modify operations if short- and long-term interest rates drop sharply further on expectational grounds."

Chairman Burns said it appeared that there were some differences of view among Committee members about the interpretation of the decisions reached at the September meeting of the Committee and about the appropriate objectives of current open market operations. He had been advised that at the telephone conference meeting held on October 2, before he had

returned from his visit to Africa, five of the eleven members participating had favored a course different from that preferred by the majority. Since that meeting, some additional information had become available about the behavior of the economy, the monetary aggregates, and the money markets. Therefore, even though a regular meeting of the Committee was scheduled for next week, he felt that it would be desirable to consider today whether any immediate adjustments should be made in the instructions to the Manager.

To open the discussion, the Chairman continued, he might note that he had strongly advocated the highly restrictive monetary policy that in fact had been pursued in recent months. It now appeared that the objective--to moderate the growth of the monetary aggregates--had been achieved. Indeed, it was possible that the restraint had been carried further than intended; the narrowly defined money supply had shown virtually no growth over the third quarter, and it had actually declined in the last 2 months of the quarter. Moreover, the growth of the other monetary aggregates had been subdued substantially. System officials had repeatedly stated to Congress and the public that the Federal Reserve intended to pursue a monetary policy that would permit moderate growth of the monetary aggregates. If the System were to allow the period of very low or negative growth in the money stock to continue much longer, it would not only

be damaging its credibility; it would be failing to meet its responsibilities to the economy and to the nation.

The Chairman suggested that Mr. Holmes be asked to report on recent open market operations at this point, and that the members then briefly state their preferences among the alternative policy courses described in the Secretary's wire. He might mention before the discussion proceeded that he regretted the necessity for limiting the participation of Reserve Bank Presidents in this meeting to those Presidents who were currently serving as members of the Committee. He personally found great difficulty in meetings of this kind--in which people communicated through mechanical instruments rather than in face-to-face discussion--and he believed that others felt similarly. To have included the seven other Presidents in the telephone hookup would, of course, have greatly compounded the difficulty.

Mr. Holmes made the following statement:

> Open market operations in the last calendar week were used aggressively to supply reserves in an effort to bring the Federal funds rate down to the 10-1/2 per cent level desired by the Committee. Despite the injection of close to $800 million in reserves through outright operations and daily repurchase agreement operations that totaled around $6 billion for the week, the funds rate stubbornly refused to come down, partly because banks cut back their use of the discount window. Finally, late last Friday, the funds rate eased and closed at 9-1/4 to 9-1/2 per cent. Yesterday, with the excess reserves supplied by open market operations bolstered by an unexpected $900 million in additional reserves

> from market factors over the long holiday weekend, the Federal funds rate declined to as low as 8 per cent, and the Desk absorbed $2-3/4 billion in reserves through matched sale-purchase agreements. Yesterday's relatively low funds rate brought the average for the statement week so far to 10.43 per cent. Today the money market opened very comfortably, with funds trading at 8-1/4 per cent.
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> Considering the reserve outlook, it appears that the System will have to be a substantial supplier of reserves in the weeks ahead. In the process we would expect to be an outright buyer of Treasury bills and agency securities. I believe that the market has already discounted a modest easing move by the Federal Reserve; but we could get some further downward movement in interest rates on evidence of that easing, particularly if the market tends to overinterpret our actions, as it often does.

Mr. Balles said he agreed with the Chairman about the danger of maintaining the present degree of monetary restraint for too long. Growth in the monetary aggregates had fallen short of the desired rates for several months, and it now appeared quite likely that their growth would be substantially below target over the whole second half of the year. If so, there would be a serious risk that the widely anticipated slowdown in economic expansion would be converted into an outright recession. He favored alternative 3 because he thought it was important to bring the monetary aggregates back toward the longer-run growth path. He believed that interest rates did not have to be as high as they were now in order to achieve the System's basic objectives. Moreover, the current high level of rates was causing serious difficulties for the construction industry

and creating fears in Congress and elsewhere of another credit crunch.

Mr. Brimmer commented that he viewed the immediate problem purely as a matter of the appropriate tactics for achieving the longer-run objective of moderate growth in the monetary aggregates. He would prefer to move more cautiously toward stimulating the monetary aggregates than was implied by the language of alternative 3. Indeed, his first choice would have been alternative 1, calling for maintenance of a 10-1/2 per cent Federal funds rate for the brief period until the meeting scheduled for next week, were it not for the apparent sentiment to take some further step today. In view of that sentiment he would support alternative 2.

Mr. Bucher said he concurred in the Chairman's remarks on the necessity of stimulating growth in the monetary aggregates, and like Mr. Balles, he was concerned about the difficulties being experienced in some sectors of the economy and about the risk of a recession next year. He supported alternative 3.

Mr. Daane observed that his major concern in considering policy decisions was not so much with attaining some precise rates of growth in the monetary aggregates as with fostering the Committee's objectives in the domestic and international areas as far as feasible through monetary policy. Recently,

those objectives had been to slow the pace of inflation, to improve the balance of payments, and to promote a sustainable rate of advance in economic activity. Only limited success had been achieved, particularly with respect to the pace of inflation.

Mr. Daane remarked that he had not seen the kinds of significant changes in the economic situation that would warrant a sharp change in monetary policy. It might be in order for policy to flex in response to the recent behavior of the aggregates and the implications for the economy. It seemed to him, however, that the particular alternatives set forth in the Secretary's telegram might already have been outdated to some extent by the latest market developments. As he understood Mr. Holmes' report today, the funds rate was now averaging below 10-1/2 per cent and it was under strong downward pressure from market forces. It seemed probable to him that the aggregates would begin to grow without further action by the Committee, and he feared that any action would only rekindle market expectations of significant easing in monetary policy. He was particularly concerned about further sharp declines in domestic interest rates because, with upward pressures on interest rates abroad, there was a possibility of substantial outward flows of funds from the United States. He preferred alternative 1 and

could accept alternative 2, but he would be unhappy with alternative 3.

At this point the Chairman asked for comments from the Committee's Senior Economist.

Mr. Partee noted that relatively little new economic data had become available since the Committee's telephone conference on October 2. There were, however, three developments which reinforced earlier indications that the performance of the economy was a little weaker than had been anticipated. First, although data for nonagricultural employment in September showed a significant advance, there was little or no increase in manufacturing employment for the fourth consecutive month. Moreover, there was a decline in production worker employment--a traditional indicator of cyclical weakness in output. The series on average hours worked in manufacturing rose substantially in September, but that could be, at least in part, a result of seasonal adjustment problems.

Secondly, Mr. Partee continued, it was learned yesterday that the earlier figures for retail sales in August were being revised downward and that, according to preliminary indications, sales were not strong in September. It appeared that the annual rate of retail sales in the third quarter was several billion dollars lower than the staff had been expecting, and that all of the increase from the second quarter reflected higher prices.

Finally, Mr. Partee remarked, there had been a substantial slowing in the expansion of business loans in September. Even if one combined business loans and dealer-placed commercial paper, the increase was considerably less in September than it had been earlier this year. That suggested to him that substantial inventory accumulation had not yet begun. While the staff continued to anticipate an inventory buildup, it had been delayed for a considerable period.

In view of those additional clues pointing to some weakness in the current state of the economy and given the further weakness reported in the monetary aggregates, Mr. Partee observed, he would recommend that the Committee undertake somewhat more active efforts to restore growth in the monetary aggregates. Accordingly, he suggested that it adopt alternative 3.

Mr. Francis remarked that the appropriate course, in his judgment, was to supply reserves to the extent necessary to get the monetary aggregates back onto the desired long-run growth path. In pursuing that course, less than customary attention should be paid to the Federal funds rate. He favored alternative 3.

Mr. Hayes observed that he concurred in much of what Mr. Daane had said. He believed the Committee was in some danger of adopting too mechanistic an approach to the short-run movements of the monetary aggregates. He was not

concerned about the apparent slowing in business loan expansion because he considered it a desirable achievement of policy; only recently, System officials had been strenuously trying to persuade banks to moderate the growth of business credit. In his view there had been no substantial change in the business situation; certainly the outlook for inflation had not improved. The international situation remained a source of concern, and as Mr. Daane had noted, interest rates abroad were rising. On a recent trip to Chicago he had found a general belief that monetary policy was easing and that interest rates would come down sharply. At the same time, there was a widespread expectation that the rate of inflation would be 5 per cent, at a minimum, over the foreseeable future. It would be highly unfortunate if such expectations persisted.

Mr. Hayes said he was inclined to focus on the longer-run growth rates of the aggregates. From that perspective, there did not seem to be any need to worry, as yet, about the recent shortfalls. He could accept a modest decline in the funds rate--say, to an average of 10-1/4 per cent. He preferred either alternative 1 or 2, and like Mr. Daane, he would be unhappy with alternative 3.

Mr. Holland remarked that his views were similar to those expressed by Mr. Balles and Mr. Partee. He thought it

would be wise to move in an orderly manner to somewhat less firm credit conditions and to encourage the gradual expansion of the aggregates. The Committee had already made some progress in that direction, and he thought the adoption of alternative 3 would be the best way of continuing to do so.

Mr. Mayo observed that alternative 2 seemed to him to be consistent with the decisions reached at the September meeting and at last week's telephone conference. He wondered whether the Committee might not be concentrating too much on very short-run movements of both the monetary aggregates and the funds rate. He would have no real objection to M_1 growth rates in the neighborhood of zero for another month or so, partly because of temporary factors in the present situation that reduced the significance of such low growth rates. He would not want zero growth to continue much longer than that, but since the Committee could consider the matter at its regularly scheduled meeting next week, he was not greatly concerned about the behavior of the aggregates at this point. And he would not want to formulate policy decisions on the basis of day-to-day fluctuations in the Federal funds rate.

Mr. Mayo commented that he would have favored alternative 3 were it not for the first sentence instructing the Desk "to provide reserves aggressively, in order to begin making up for

recent substantial shortfalls in growth of RPD's and other monetary aggregates." To him, that language implied operations that would push the funds rate down sharply--perhaps to the area of 8 or 9 per cent. He would be content if the funds rate were at the 10 per cent level next week.

Chairman Burns expressed the view that the essence of alternative 3 was contained in the expectations for the funds rate specified in the second sentence, rather than in the more general language of the first sentence. He suggested that in expressing their preferences among the alternatives the members ignore the first sentence of 3.

Mr. Mayo said he would support alternative 3 on that basis. He added that he was not concerned about the low level to which the funds rate had fallen yesterday and today, because that was a consequence of factors related to the long holiday weekend. If because of market factors the funds rate should remain at, say, a 9-1/2 per cent level, he would not want the Desk to feel that it was obliged to push it back up to 10-1/4 per cent.

Mr. Daane concurred in that observation.

Continuing, Mr. Mayo remarked that while the strong demand for seasonal agricultural credit which had been anticipated in his District had not yet developed, there still was

a potential for increased demand later this year. Finally, he thought that the Committee should not put too much emphasis on historical relationships and linkages in assessing the degree of change in credit conditions. He did not find it surprising that the spread between the Federal funds rate and other short-term rates was unusually wide at this time. Given market expectations with respect to interest rate movements, it was logical that banks should bid for Federal funds rather than aggressively market CD's, keeping the funds rate up in the process. That appeared to him to be a normal adjustment to changing interest rates. He thought policy was about on track at the moment.

Mr. Mitchell observed that he could agree with much of what Mr. Mayo had said. He added that he had come to the meeting with a preference for a course somewhere between those specified by alternatives 2 and 3. After listening to the Manager's report, however, he concluded that he would have no objection to a funds rate of 10 rather than 10-1/4 per cent, particularly if the Manager did not have to press hard in either direction to maintain a 10 per cent rate. Since the present statement week was almost over, any instructions given would, of course, apply mainly to the following week. He would support alternative 3, as amended.

Mr. Morris expressed the view that the Committee had made the correct decision at the September meeting, and that data becoming available since then had tended to support that decision. He had been disturbed because, until the last few days, the September decision had not been implemented as a consequence of what struck him as undue apprehension about market expectations. Not only had the targets for the aggregates not been achieved; the rate at which reserves had been supplied had not come close to the objective. He did not think it would be possible to get back to the desired paths in the week remaining before the October 16 meeting, but he would want to move fairly aggressively in that direction. Therefore, he supported alternative 3.

Mr. Sheehan said he agreed with the remarks made by all of those who had supported alternative 3. In the interest of brevity, he would simply note that he favored that alternative also.

Chairman Burns observed that neither alternative 2 nor 3 represented a precipitate action. In his judgment, alternative 3--which he favored--was entirely consistent with the decision the Committee had reached at its September meeting to begin leaning a little in the direction of ease. He believed that that was the correct decision in light of both the information which

was at hand at the time and which had become available subsequently. Since alternative 3 represented only a modest move in the direction of easing, it could easily be reversed if it should prove to have been mistaken.

Mr. Daane remarked that while he had previously expressed a preference for alternative 1 or 2, he was willing to support alternative 3 as amended to delete the instruction of the first sentence to "provide reserves aggressively." He would not want to see the Manager move aggressively at this time either to raise or to lower the funds rate.

Mr. Hayes observed that there were relatively few business days remaining before the meeting of the Committee scheduled for October 16. He wondered whether it was meaningful to expect the Manager to implement alternative 3, which called for a two-stage decline in the funds rate, in so short a period.

Mr. Brimmer said he thought the direction was more important than the precise pattern of movement. With respect to his own earlier comments, he had stated his preference for alternative 2 before he had heard Mr. Partee's remarks and before the Chairman had suggested deleting the first sentence of alternative 3. Like Mr. Mayo, he had objected to the word "aggressively," and he would now be willing to support alternative 3.

Mr. Balles remarked that he was somewhat dismayed at the deletion of the first sentence of alternative 3. Although he, too, had reservations about the word "aggressively," he would like to see reserves supplied rather actively in order to make up the recent shortfalls and get the aggregates back on the long-run growth paths the Committee had specified.

Chairman Burns said he thought it was appropriate to delete the first sentence of alternative 3 because specifications paralleling those given in the other alternatives were confined to the second sentence. However, each member was free to interpret the purpose of the amended 3 as he chose; he would find the deleted first sentence expressive of his own thinking if the word "aggressively" were dropped.

Mr. Hayes said he did not believe that it would make much difference whether the Federal funds rate was 10-1/4 or 10 per cent over the next few days, but it would be a matter for concern if the market thought the System was moving toward a sustained and substantial decline in the funds rate. Since the Committee would have a chance to consider the matter at its meeting next Tuesday, he was willing to join the majority in supporting alternative 3 at this time.

The members were then polled on their preferences. The poll indicated unanimous agreement on alternative 3, as amended.

Thereupon the meeting was adjourned.

Secretary