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 Wednesday, February 20, 1974, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Balles
Mr. Brimmer
Mr. Bucher
Mr. Daane
Mr. Francis
Mr. Holland
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Sheehan

Messrs. Clay, Eastburn, Kimbrel, and Winn, Alternate Members of the Federal Open Market Committee

Messrs. Black, MacLaury, and Coldwell, Presidents of the Federal Reserve Banks of Richmond, Minneapolis, and Dallas, respectively

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, Bryant, Eisenmenger, Gramley, Reynolds, Scheld, and Sims, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account
Mr. Sternlight, Deputy Manager, System Open Market Account

Mr. Melnicoff, Managing Director for Operations and Supervision, Board of Governors
Mr. Feldberg, Secretary to the Board of Governors
Mr. Coyne, Assistant to the Board of Governors
Mr. Pierce, Associate Director, Division of Research and Statistics, Board of Governors
Messrs. Keir and Wernick, Advisers, Division of Research and Statistics, Board of Governors
Mr. Pizer, Adviser, Division of International Finance, Board of Governors
Mr. Wendel, Assistant Adviser, Division of Research and Statistics, Board of Governors
Miss Pruitt, Economist, Open Market Secretariat, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Boehne, Parthemos, Taylor, and Doll, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Richmond, Atlanta, and Kansas City, respectively
Mr. Garvy, Vice President and Senior Adviser, Federal Reserve Bank of New York
Messrs. Hocter 1/ and Green, Vice Presidents, Federal Reserve Banks of Cleveland and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on January 21-22, 1974, were approved.

1/ Attended morning session only.

Chairman Burns said he wished to advise the Reserve Bank Presidents that yesterday the Board had acted unanimously to disapprove a proposal by a Reserve Bank for a reduction in the discount rate from 7-1/2 to 7-1/4 per cent. While individual members of the Board may have placed varying degrees of emphasis on particular considerations in their own thinking, a number of factors were taken into account in the decision. One was a judgment that the slowdown in economic activity was not by any means due entirely to a deficiency in aggregate demand; on the contrary, shortages of fuel and other materials had played and were continuing to play a significant role in the slowdown. Another was that, while short-term interest rates had declined rather sharply over the past month, the discount rate was still well below the Federal funds rate and thus remained a subsidy rate. A third consideration which had some influence was that the monetary aggregates apparently were rising at rapid rates in the current month. And finally, all members of the Board agreed that this was not the time to issue a dramatic signal of an easing in monetary policy; they thought that whatever easing they would like to see should take a less dramatic and obvious form.

The Chairman then invited Mr. Daane to comment on the February Basle meeting which the latter had attended.

Mr. Daane observed that during the afternoon session of the meeting, the central bank governors present reported on developments in their individual countries. A great deal of concern was expressed about the rapid rates of increase in wages and prices, reflecting both the energy situation and other factors, and the discussion was not very cheerful. President Zijlstra's conclusion was that a reduction in inflation rates to 10 per cent would have to be considered a good outcome.

During the dinner session, Mr. Daane continued, the governors returned to the question of the financial consequences of the energy crisis, with particular reference to possible repercussions on the Euro-currency market. President Zijlstra raised such questions as whether the Euro-banks could actually absorb the volume of funds expected to flow into the Euro-currency market, and what effects such flows would have on the liquidity and solvency of the market. He also asked whether the BIS could play a useful role; while he did not spell out his meaning in detail, he indicated that he was thinking of a role for the BIS both as a conduit and as a lender of last resort. The discussion was rather diffuse and no specific conclusions were reached. There was a general feeling, however, that the sheer magnitude of the anticipated flows would exacerbate a long-standing problem in the Euro-currency market resulting from the fact that liabilities were of short term and assets were of intermediate or longer term.

Mr. Daane noted that in the latter part of the discussion he asked about the expectations of individual countries with respect to appropriate holdings of reserves and levels of exchange rates. There was no real response to his question. The Washington Energy Conference had begun on the day of the Basle meeting, and since the Finance Ministers would be discussing the financial implications of the energy problem at that Conference, the governors seemed to feel that no useful purpose would be served by pursuing questions of appropriate reserve levels and exchange rates at Basle.

Mr. Daane added that President Zijlstra had asked the standing committee on the Euro-currency market to meet at the time of the next Basle meeting or earlier for the purpose of considering prospective developments in the Euro-currency market as related to the financial flows arising from the oil crisis.

Chairman Burns then said he would comment briefly on the Energy Conference that had been held in Washington last week. The objective had been to arrive at a common policy among the industrial countries, and perhaps among oil-consuming countries in general, for dealing with the energy problem. A decision was reached at the Conference to set up working groups with the following assignments:

to seek agreement among the industrial countries, and perhaps others, on conservation measures in the use of energy; to seek agreement on cooperative research and development efforts; to develop a formula for sharing energy supplies in times of emergency and severe shortages; to consider financial mechanisms for adjusting to the oil problem; to draw up guidelines for any bilateral conversations that might take place between oil-consuming and oil-producing countries; and to develop proposals that could be made to the oil-producing countries in a joint conference. In effect, the Conference adopted the U.S. proposal virtually as it was presented. Three days were required to reach that conclusion because one country--France--could not accept the U.S. proposal.

In concluding, Chairman Burns noted that copies of documents relating to the meeting would be distributed to members of the Committee.

The Chairman then called for the staff report on international developments.

Mr. Bryant said that in the interest of saving time this morning he would not read the statement he had prepared, but would instead submit it for inclusion in the record and make only a few points orally.[1/] First, there were good reasons for apprehension

1/ The text of Mr. Bryant's statement is appended to this memorandum as Attachment A.

about the world payments situation. Further study during the past month had not resulted in a reduction of the earlier estimates of the impact of the oil price increase. Very difficult problems were going to be encountered in financing the enlarged flows of payments for oil. The impact would be particularly heavy on some of the less developed countries, whose situation could accurately be described as desperate. It also would be quite heavy on a few industrial countries, notably Italy and the United Kingdom. The chances were good, for example, that strong pressures would develop on exchange rates for the lira and sterling during coming months.

Secondly, Mr. Bryant continued, there were also grounds for apprehension about the way in which the world economic situation was developing. On the one hand, the risk of a generalized downturn in real economic activity in the industrial countries seemed to be at least as great now as it had seemed 2 months ago, when he had commented on it at the December meeting of the Committee. On the other hand, the prospects for inflation had also worsened greatly over that interval. Judgments about the likelihood of a general downturn in real activity necessarily had to be based partly on prospective analysis; conclusive evidence on that score was not provided by statistics already in hand. In particular, the bulk of one of the effects that analysts were most concerned about--the deflationary impact on demand of the oil price increases--would not yet be evident in the available statistics.

His third point, Mr. Bryant observed, was that the countries with weak balance of payments positions--again, notably Italy and the United Kingdom among the industrialized nations--would not be in a position to take the lead in stimulating domestic demand, should such action be called for. Thus, he was led to his fourth, and concluding, point: should evidence accumulate that a generalized downturn in economic activity was under way, it would be highly important for countries in stronger payments positions to take the lead in adopting stimulative measures. He had particularly in mind the United States and Germany, two major countries on which the adverse balance of payments consequences of the oil situation apparently would fall less heavily than they did on others. It needed emphasizing that the outlook for economic activity and for the balance of payments were highly inter-dependent. While Italy or the United Kingdom could pursue internal policies designed to direct resources toward their export industries, the extent to which their exports actually expanded would depend critically on the evolution of demand in the economies of their trading partners.

Mr. Coldwell asked Mr. Bryant to amplify his comment regarding the need for countries like the United States and Germany to take the lead in adopting stimulative measures.

In reply, Mr. Bryant observed that domestic needs should, of course, be the primary determinant of domestic stabilization policies. If it appeared, however, that there was a significant danger of a general downturn--and the U.S. economy at the moment appeared to be a bit further along in the cycle than Europe--it would become quite important for the evolution of the world economy that the United States promptly take such stimulative measures as were appropriate. If it did not, the rest of the world would be in an even more difficult situation than was already foreseen.

Mr. Brimmer asked what implications Mr. Bryant's analysis had for appropriate levels of exchange rates.

In reply, Mr. Bryant said he felt even more strongly than he had earlier that prospects for reaching international agreement this year on a new set of par values were extremely poor. As for the movement of exchange rates in the market, on balance he thought there was a likelihood of upward pressures on the dollar as funds began to flow back from the oil-exporting countries to the Euro-dollar market and on into national capital markets. The extent to which the dollar should be permitted to appreciate as a consequence of such net flows to the United States was a difficult matter that would need to be determined in consultation with other major countries.

Mr. Daane observed that at the WP-3 meeting in Paris last week, which both he and Mr. Bryant had attended, the OECD Secretariat had taken a position similar to Mr. Bryant's about the need for the countries in stronger payments positions to take the lead in preventing world-wide deterioration of economic activity. Among other things, as pointed up by the OECD Secretariat, that would suggest the desirability of an appreciation of the dollar. However, he (Mr. Daane) had been puzzled by one aspect of the Secretariat's position, relating to the timing of the anticipated downturn; in contrast to widespread expectations in the United States that activity would be slow in the first half of 1974 but would turn up in the second half, the Secretariat expected a world-wide downturn to occur in the second half.

Also, Mr. Daane remarked, some participants in the WP-3 meeting--notably the Germans--were strongly of the view that the greatest danger was not of economic downturn but of uncontrolled world-wide inflation. The debate revolved around the question of whether the oil price increase should be considered analogous to an indirect tax--a form of forced saving. Mr. Bryant appeared to be more inclined to the OECD view--in his (Mr. Daane's) judgment, with considerable justification--but the inflationary danger could not be dismissed.

Mr. Bryant said he was, indeed, more worried than the German representatives at the WP-3 meeting had appeared to be about the risk of a general economic downturn. However, he did not have a firm position in the controversy between the OECD Secretariat and the Germans, because the evidence was not yet conclusive. His position was a conditional one--that if strong evidence of a downturn began to accumulate, it would be quite important for the United States to act as soon as possible, within the constraints imposed by the need to give priority to domestic considerations. The difference of view Mr. Daane had mentioned with respect to the likely timing of the expected downturn was quite important. The OECD Secretariat thought that the contractionary effect of the oil price increase would reach a peak in the second half of the year. Accordingly, the Secretariat disagreed strongly with the national forecasts in most countries, including the United States, that economic activity would be recovering then.

Chairman Burns remarked that the Finance Ministers of leading countries with whom he had talked at the Energy Conference had placed more stress on the objective of maintaining aggregate demand than on that of fighting inflation. In effect, they were taking a Keynesian view of the matter and would probably act accordingly.

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 from January 22 through February 13, 1974, and a supplemental report covering the period February 14 through 19, 1974. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs made the following statement:

> At the time of the Committee's last meeting the dollar was continuing to strengthen pretty much across the board. Since January 29, however, this trend has been abruptly reversed by three major developments: first, the removal of our capital export controls; second, a similar sweeping removal of foreign restraints on capital inflows; and third, a decline in U.S. interest rates while European rates have held firm or even risen. Nearly every day since then, the dollar has continued to lose ground against the European currencies and is currently being quoted around 7 per cent below its January peak. This is a rather sizable decline. Meanwhile, the London gold price has moved up to a new high of $150 and is probably both reflecting and aggravating the dollar's decline. In general, the market seems to have made a major revision in its judgment of the relative effects of the energy crisis on the United States and other countries.
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> So far, the exchange markets have remained reasonably orderly, with most of the declines in dollar quotations seeming to reflect precautionary markdowns rather than a yielding under pressure to sudden flows of funds. We have not intervened during this period,

while foreign central bank intervention has been negligible, except by the Bank of Italy. Next month, however, not only the exchange markets but also the Euro-dollar markets will begin to feel the first impact of massive transfers to the oil-producing countries. At the moment, a number of the European central banks as well as many market participants are still inclined to think that the oil-producing countries will at least initially place the bulk of their receipts at short term in the Euro-dollar market, with considerable reliance on Swiss banks as intermediaries. But as the dollar has weakened in recent weeks, there is renewed talk of the likelihood of special deals between the oil producers and Switzerland, Germany, and perhaps other countries, which will enable the producers to receive payment in Swiss francs and other strong currencies for investment at reasonable rates of interest. This bypassing of the dollar could turn into a vicious circle, of course, if the dollar continues to slip.

A second major uncertainty relates to the effect on the Euro-dollar market of such sudden heavy placements of oil revenues. The recycling of Arab money to oil-consuming countries will be easy enough where good credit risks are involved, but there are clearly a lot of countries that would encounter difficulties even now in borrowing in the Euro-dollar market. Others, such as Italy and the United Kingdom, which have already borrowed sizable amounts, may well find as time goes on that Euro-dollar lenders will tend to back away from new British and Italian credit demands. In effect, the Euro-dollar market could find itself suddenly swamped--within just a few months--with heavy inflows of short-term funds without a corresponding growth of safe investment outlets also at reasonably short term. From time to time, therefore, we might find sudden heavy overflows of funds out of the Euro-dollar market either to New York, Japan, or the continental markets in response to interest rate differentials. Finally, we have the impression that New York commercial and investment bankers are now aggressively seeking out lending opportunities abroad. If such lending develops in big volume, the balance of payments scales could be easily tipped against us with a consequent further depreciation of the dollar. At the moment, I don't think it is possible to forecast whether these prospective flows of capital will be to our advantage or disadvantage but we may get a clearer view within a month or so. One thing is clear right now--international capital flows will be abnormally sensitive to whatever interest rate differentials may develop.

Meanwhile, the prospectively massive transfers of funds from U.S. oil companies to the oil-producing countries create an urgent need for both Mr. Holmes and myself to have some advance notice of the timing and scale of such payments. Quite aside from the sudden impact on the exchange market of such transfers, we could also see in a matter of a few days' time several billion dollars suddenly shifted from our short-term markets into the Euro-dollar market--and then, perhaps to other markets. Accordingly, I think that it would be useful to approach the treasurers of the major U.S. oil companies to see if they cannot give us on an informal and confidential basis timely information on their scheduled payments to the oil-producing countries. In this connection, I might note that one of the major oil companies, which has been supplying the foreign trading desk for some years past with advance information on major exchange transactions, has already volunteered to give us information on payments to the oil-producing countries in a regular, comprehensive, and timely way, and I would hope that the other oil companies would also be cooperative.

Mr. Mitchell expressed the view that the oil companies had information in addition to their scheduled payments which would be useful to the Account Manager.

Mr. Coombs agreed, but added that the receipt of information on payments would be an important start. If personnel from the New York Bank--perhaps one member of his staff and one of

Mr. Holmes' staff--were to visit the treasurers of the major oil companies and explain the System's needs, it should be possible to arrange an informal telephone reporting system rather quickly. It would be necessary, of course, to provide the oil companies with assurances that the data they provided would be held in confidence.

Mr. Brimmer referred to Mr. Coombs' comment that New York bankers were aggressively seeking lending opportunities abroad, and asked whether they were also soliciting deposits, particularly of oil money.

Mr. Coombs replied that he had not heard reports of such solicitations. The emphasis appeared to be on arranging standby credits, in some cases of great size. For example, one European central bank had been approached by a New York commercial bank with an offer to put together a $1 billion line of credit--a sum considerably in excess of that central bank's swap arrangement with the Federal Reserve.

Chairman Burns asked whether Mr. Coombs found such credit solicitations disturbing for reasons connected with the foreign exchange markets, with the quality of the prospective credits, or both.

Mr. Coombs replied that his primary concern was with the possible consequences for the foreign exchange markets. Questions of credit quality were relevant in that connection, but he had not meant to pass judgment on the U.S. bankers' credit appraisals.

Mr. Holland referred to the discussion at the January FOMC meeting of the prospects for repaying the System's outstanding swap debts and asked about the current status of that matter.

Mr. Coombs replied that there had been little change in the situation over the past month. The System had stopped making repayments on its Belgian swap debt at the end of October at the request of U.S. Treasury officials, who hoped through negotiation to get the Belgians to agree to honor the revaluation clause that had been in the swap contract at the time the drawings in question had been made, before closure of the gold window in August 1971. The National Bank of Belgium argued that the revaluation clause did not apply, on the grounds that the shift from a fixed parity for their currency to a central rate under the Smithsonian agreement did not constitute a revaluation. The most recent development was the transmittal to the Belgian Finance Minister of a Treasury memorandum on the matter. If the Belgians were to agree to the Treasury view, the United States would save roughly $8 million; but during the period of nearly 4 months that the question had been under negotiation, the System had incurred about $6 million in additional interest charges.

Mr. Coombs added that the Treasury's position had caused the System to miss an excellent opportunity to purchase Belgian francs in the market in December and January, when they had been available at an 8 per cent discount. Since the previous meeting it had purchased $20.4 million of francs, including $13.5 million from the Treasury, in anticipation of future debt repayments. Most recently, when the franc rose to the top of the narrowed "snake," the Belgian authorities had asked the System to discontinue its market purchases, to avoid adding to the upward pressures on their currency. If the franc should weaken again, however, the Belgians would no doubt welcome System purchases. If the franc were to depreciate to, say, 3 per cent below the central rate, he thought it would be desirable to press the Treasury to withdraw its objection to the System's buying the amounts necessary to clear up its outstanding debt in that currency.

Mr. Holland expressed the view that the System should leave no stone unturned in the effort to reach an understanding that would enable it to repay its Belgian franc debt when the rate for that currency weakened. He then asked about the situation with respect to the outstanding debt in Swiss francs.

In reply, Mr. Coombs noted that the Swiss franc was now well above its computed central rate. The Treasury had sent the Swiss a memorandum stating the current Treasury position that the Swiss should bear the full cost of any excess over the computed central rate the System had to pay in acquiring francs to apply to the debt. In his judgment, there was virtually no chance that the Swiss authorities would accept the Treasury's view.

Mr. Holland asked whether there was anything the Committee could do to expedite repayments of the debts in question.

Mr. Coombs replied that it would be worthwhile to point out to the Treasury that the delay in repayments thus far had proved quite costly, and to stress the importance of clearing up the debts at the earliest possible date. He was particularly concerned about the risk of further delays because of the possibility that the System would soon find itself in the position of a creditor on some of its swap lines.

Mr. Eastburn referred to Mr. Coombs' comment about the sensitivity of capital flows to interest rate differentials, and asked whether Mr. Coombs thought the Committee should attempt, as a policy matter, to influence those differentials.

Mr. Coombs replied in the negative. He had meant simply to suggest that the members remain alert to the possible emergence of interest rate relationships that could lead to serious difficulties for the dollar.

By unanimous vote, the System open market transactions in foreign currencies during the period January 22, 1974, through February 19, 1974, were approved, ratified, and confirmed.

Mr. Coombs then noted that at the February Basle meeting he had had inquiries from representatives of both the Bank of England and the Bank of France regarding the status of the revaluation clause in the System's swap line with the Bank of Italy. He had replied that the clause had been deleted in that specific case, but that the Open Market Committee had not yet reached a conclusion regarding the general applicability of such a change. In fairness to the Bank of England and other central banks that might suddenly be forced to look to the System for help, he was inclined to think that the System should clarify the terms on which its swap partners could draw on the lines by generalizing the policy followed in the Italian case--i.e., providing that the foreign borrower would assume the entire risk of exchange rate movements. In his judgment, the System had no other good alternative, since it would not be reasonable to give other central banks more favorable treatment than had been given to the Bank of Italy.

Mr. Mitchell asked whether there was any ambiguity in the understanding with the Bank of Italy.

Mr. Coombs replied that in his judgment there was not; it was specified in telexes exchanged with the Bank of Italy at the time the Italian swap line was enlarged that the revaluation clause was deleted from the swap contract. The presumption was that the

Bank of Italy, rather than the Federal Reserve, would be the borrower, and in the absence of a revaluation clause the borrower would bear the full exchange risk.

In response to a question by the Chairman, Mr. Bryant said he agreed that there was no ambiguity with respect to borrowings by the Bank of Italy. There might, however, be some residual ambiguity in connection with any drawings the System might want to make, since the provision for a 50-50 sharing of profits and losses on Federal Reserve drawings was still included in a number of the swap lines.

Mr. Hayes commented that it would seem to be a fair assumption that the understanding reached with the Bank of Italy would apply reciprocally, so that the System would assume the full exchange risk on any drawings it might make.

Mr. Coombs said he did not think that bridge had been crossed as yet.

Chairman Burns agreed with Mr. Coombs' comment.

Mr. Holland asked whether Mr. Coombs was proposing that the System take the initiative in advising its swap partners that they would be expected to assume the exchange risk on any drawings they might make.

Mr. Coombs replied in the negative. His proposal related simply to the response that should be given to any swap partner raising the question.

Chairman Burns agreed that the System should not take the initiative in the matter, since that could be interpreted as an invitation to the other parties to draw on the swap lines--an invitation that should not be extended.

The Chairman then asked whether there was any objection to the type of response Mr. Coombs had suggested be made to inquiries about the terms on which other parties could draw, and no objections were raised.

Mr. Holland suggested that it would be helpful to have a staff memorandum on the question of the position the System should take regarding exchange risks in the event it should desire to draw on the swap lines in the future.

Mr. Coombs agreed that such a memorandum should be prepared soon. Indeed, the question was related to his next recommendation, concerning the swap line with the National Bank of Belgium. As the members might recall, when the System renewed its swap lines last December, all of the renewals except that of the Belgian line were for a full year. The Belgians were agreeable to an extension for only 3 months--perhaps because they had anticipated the question just raised about System drawings and had sought to arrange matters so that that question would be considered at an early date. The Belgian swap line, like those with the central banks of Germany and the Netherlands, still contained the provision introduced last July for a 50-50 sharing of profits and losses on System drawings. It was possible that the Belgians would agree, when the line reached the end of its term in late March, to retain the 50-50 provision. It was more likely, however, that they would suggest reverting to the proviso that had been in the swap contract before July--to the effect that, if either party desired to make a drawing, the two parties would discuss the terms and conditions of a revaluation clause, if any. If that should be the Belgian preference, he would suggest that the System agree to it. Such a proviso had been included in a number of System swap contracts for some time, and it had been restored to the contract with the Bank of France last December.

After discussion, the Chairman asked whether there was any objection to Mr. Coombs' suggestion, and none was raised.

Mr. Coombs noted that the swap line with the National Bank of Belgium matured on March 29, 1974. He was not sure whether the Belgians would prefer to renew the line for a full year or for some shorter period, and would recommend that the Committee authorize renewal for a period of up to one year.

By unanimous vote, renewal of the swap arrangement with the National Bank of Belgium for a further period of up to one year was approved.

Chairman Burns 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 made the following statement:

The most recent economic data leave little room for doubt that the pace of activity in the United States, if not elsewhere, is now moving in a downward direction. Thus, the index of industrial production declined again in January, and by more than in December. Retail trade showed some rebound from the depressed December volume but remained quite weak in real terms. And nonfarm employment last month dropped substantially; the reduction was widely distributed by lines of activity, and there was also a sharp break in the average length of the workweek.

Much of the decline to date has been related to reductions in demand stemming from the fuel shortage. The sharp cutbacks in automobile production and electric power output over the past 2 months account for most of the drop in industrial production, and the reduction in consumer mobility--including tourist travel--probably is responsible for the unusual weakening of employment in retail trade and service establishments. But other sectors of the economy have been soft too, including homebuilding, where housing starts increased very little in January from the depressed December rate, and commercial construction, where new contract awards dropped off sharply towards year end. Also, there is a question as to how long business will continue to accumulate inventories at the recent pace, if final demands continue slack.

As a result of the sharper-than-anticipated output curtailments, the staff has reduced its GNP projection, as presented in the green book.[1/] Real GNP in the first quarter is now expected to decline by about 3 per cent, at an annual rate, with a further small decline the most likely prospect for the second quarter. Thereafter, real GNP is expected to begin a moderate recovery, paced by rising output and sales of small cars and an upturn in residential construction, and with continued expansion in business fixed investment a sustaining factor. The new Federal budget numbers, as interpreted by the staff, do not change this economic projection appreciably, though there could well be a move to provide somewhat more stimulus from this source if, as we are projecting, unemployment rises to exceed 6 per cent before the end of the year.

The staff projection for the real economy is a little weaker than most of those that have been publicized, both as to the extent of the first-half decline and the speed of recovery expected in the second half of this year. This, I think, is due mainly to the marked slowing in inventory accumulation that we expect as the year progresses, and to the relatively sluggish recovery anticipated in housing. Also, we continue to assume that the embargo on imports of Arab oil will continue throughout the year. If the embargo is relaxed or ended shortly, the resulting improvement in attitudes could provide some additional stimulus to spending, although the extent to which oil supply actually improved would depend on the production schedules of the exporting countries.

Aside from the restrictive assumption that the oil embargo will persist, however, I am inclined to view our current economic projection as having more risk exposure to being too high, rather than too low. Even though the problems to date center on the uncertain availability and rising price of oil, the effect

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

is to destroy jobs and to divert income from consumers, where the propensity to spend is high, to oil exporters and oil companies, where the incremental propensity to spend is probably quite low. Thus, income is being diverted from the active spending stream, and this could lead to a more generalized weakening in demands and a process of cumulating erosion in attitudes and spending plans.

There are at least three areas in which the weakness in demand could be greater than we suspect. First, inventory investment could fall away even more than we are projecting. The recent rate of accumulation has been very substantial, and there could well be further acceleration in some lines now that final demands are tending to decline. I am well aware that the lists of materials and supplies that are critically short--as reported in the red book,[1/] and by the purchasing agents, and elsewhere--are still quite long, but they could evaporate quickly if there is a significant decline in world-wide output by the consuming industries, and particularly so if industrial commodity prices begin to show a convincing decline.

Second, our projections of an upturn in housing starts by about the middle of this year could turn out to be too optimisitc. Consumer sentiment is very unfavorable, and real incomes are still on the decline. There is great uncertainty about the price and availability of gasoline and of heating oil, and the price of new housing is high and still rising. Meanwhile, builder sales have been poor and their inventories of unsold houses have risen to record levels. The availability of mortgage credit is improving, and lending terms--perhaps more than rates--are likely to be liberalized in the months ahead. This has always produced a rise in housing volume in the past, but uncertainties on the part of both builders and buyers could delay and dampen the response in the current environment.

Third, we are projecting a considerable further rise in exports of goods and services this year, amounting to an increase of 11 per cent from the fourth

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

quarter of 1973 to the fourth quarter of 1974. Much of this expansion in dollar volume represents inflation, of course, and agricultural exports continue to account for a sizable share of the total. Nevertheless, with dollar exchange in great demand in order to pay for oil imports and with virtually all of the importing countries expected to incur sizable current-account deficits, I wonder whether there might not be a downturn this year in foreign demands for U.S. goods. The odds that this might happen would seem all the greater if there is a significant weakening in world-wide economic activity as the year progresses.

These worries may simply represent the misgivings of a professional forecaster in uncertain times. At present, there is little tangible evidence that a weaker economy than we are projecting is likely to develop. We will be watching carefully for such signs, but meanwhile one cannot escape the clear and present evidence of continuing intense inflationary pressure. Commodity prices are still rising rapidly, and the price indexes are escalating at a record pace. Unit labor costs also are advancing strongly, and there is little respite in prospect, with wage rates continuing to show sizable gains and productivity growth projected to continue sluggish. The recent labor contract in aluminum calls for a relatively modest increase in straight wages, but it provides for full cost of living protection for workers and partial protection in the future for those on pension. If this is a pace-setting contract, which seems likely, it underscores the importance of reducing the rate of inflation, not only as an end in itself but also as a means of moderating future increases in wage rates.

Mr. Eastburn referred to Mr. Partee's observation that the staff projection was more likely to overstate than understate the rate of real growth in 1974. He asked whether the opposite was the case with respect to the projected rate of inflation.

Mr. Partee replied that he would feel less confident about such a statement than about the one he had made regarding real output. The rise in the price deflator projected for the second half had been increased by several tenths of a percentage point to allow for the termination of wage and price controls. Perhaps that was not enough; but as he had noted at the previous meeting of the Committee, the Board's econometric model suggested that the ending of the controls program would not result in a substantial increase in prices. There were some areas in which there was a potential for sharp price increases; for example, if the oil embargo were to be lifted before the end of the year, gasoline prices would probably rise substantially further because a larger proportion of the total supply would be derived from foreign crude, which was considerably more expensive than domestic oil. In addition, given the current limited numbers of meat animals in feedlots, prices of meats were not likely to decline in the short run and might even rise. On the other hand, the rate of inflation could be less than projected if, as he was inclined to expect, world commodity prices were to move downward in the second half of 1974. On balance, he did not have strong feelings as to whether the price projections were more likely to be over- or under-statements.

Mr. Black asked whether the staff would be inclined to change the timing of the expected upturn in housing starts if the assumed level of short-term interest rates were reduced by, say, 50 basis points.

Mr. Partee responded that he was not sure that a further decline in short-term rates of that magnitude would have a significant impact on housing activity. Such a development might put some downward pressure on mortgage rates, by leading to somewhat larger inflows to lending institutions. However, deposit inflows to nonbank thrift institutions were now at comfortable levels, and growth of consumer-type time deposits at commercial banks--which had been the major supplier of mortgage funds in the fourth quarter--were substantial. With the 3-month bill rate currently at about 7 per cent, those inflows probably would be maintained.

In his view, Mr. Partee continued, the real question concerned the likely strength of the demand for housing. Inventories of unsold new single-family homes at the end of 1973 were close to record highs; at the low current level of sales, those inventories represented a full year's supply. It was not clear that builders would want to expand their operations, given the large stock of unsold homes and the uncertainties about the demand for housing. It would be necessary to wait and see if housing demand picked up in the spring as it usually did.

Mr. Sheehan observed that usury ceilings had been a limiting factor and wondered if housing activity might turn up when mortgage rates dropped below those ceilings.

Mr. Partee remarked that a decline in mortgage rates would be helpful in those 10 states in which usury ceilings were currently a constraining factor.

Mr. Bucher noted that Mr. Partee's statement about comfortable deposit inflows, while correct for savings and loan associations, did not apply to mutual savings banks in New York City, according to figures for January.

The Chairman observed that savers in large money centers, such as New York, were quite sensitive to interest rate differentials.

Mr. Morris said that view was supported by the different experience in January of savings banks in the Boston area, where deposit performance was weak, and of such banks in outlying areas, where it was strong.

Mr. Partee commented that rates on alternative investment instruments had declined quite a bit since January, reducing the attractiveness of such instruments to sophisticated investors. He might also note that in recent years mutual savings banks had been buying larger amounts of corporate bonds and had become relatively less important as a source of funds to the mortgage market.

Mr. Hayes remarked that outside New York and the metropolitan areas of New England, inflows of mutual savings banks seemed to be improving somewhat.

Mr. Black asked when the staff thought the trough in automobile sales might be reached.

In reply, Mr. Partee observed that sales of domestic autos had run at a seasonally adjusted annual rate of around 7.5 million units during the first 10 days of February; since the production rate was about 7 million units, inventories had begun to decline somewhat. However, manufacturers had been offering special rebates to dealers in an effort to stimulate sales of large cars, so that part of the recent sales volume probably should not be considered to reflect underlying demand. It was his feeling that the low in sales of domestic cars--at a rate of about 7 million units--was not too distant. A substantial increase in the industry's capacity to produce small cars was expected in connection with the introduction of the 1975 models, and the staff was projecting an upturn in sales in the second half of 1974 as a result of the greater availability of small cars expected then.

Mr. Kimbrel noted that large tax refunds would be made in the spring. He asked if the staff expected consumers to use those refunds primarily to increase their expenditures or to add to their savings.

Mr. Partee said the staff expected the refunds to amount to about $25 billion, an increase of $3 billion over 1973. In his opinion consumers would put a larger-than-average proportion of those funds into savings.

Mr. Coldwell remarked that conversations with retailers in the Eleventh District indicated that they were quite satisfied with their January sales, although sales in the early part of February were somewhat below expectations. One large retailing chain reportedly was expecting some decline in sales in real terms for the year 1974, but in general, retailers' forecasts for coming months did not appear to be pessimistic. While it was difficult to predict consumer behavior in the present situation, it seemed to him that, except in the event of a world-wide recession, the major risk was still that of inflation. If he was interpreting Mr. Partee correctly, however, the latter seemed to feel that a demand-induced decline in activity now appeared more likely than it had a month ago.

Mr. Partee agreed that Mr. Coldwell had interpreted his remarks correctly. The situation was complex, but it appeared that energy shortages had not accounted directly for sizable reductions in output. Rather, the decline in activity that had occurred thus far appeared to be mainly attributable to a reduction in demand for goods and services, especially those closely related to the use of gasoline, as a consequence of higher prices and of shortages perceived by the consumer. Several months ago Chairman Burns had outlined a possible two-stage process, involving first a reduction in expenditures on fuel and on products dependent on the use of fuel, and then--as aggregate income fell--a reduction in demand for other goods and services. It seemed to him (Mr. Partee) that there were increasing signs that the second stage was beginning to develop. For example, personal income had dropped in January, for the first time in several years.

The Chairman asked how large the drop in employment thus far had been.

Mr. Partee replied that nonfarm employment had fallen by about 50,000 in December and 260,000 in January, so that the total decline over the 2-month period was a little over 300,000.

The Chairman observed that he had seen one estimate that energy-related layoffs amounted to about 300,000.

In response, Mr. Partee noted that data had been collected on energy-related unemployment insurance claims since late November, and the cumulative total of such initial claims through February 2 suggested that there had been about 340,000 energy-related layoffs over that period. Although the unemployment insurance claims statistics could not be related directly to changes in total unemployment because of differences in concepts and in the time periods covered, he agreed with the Chairman that the energy shortage was a significant factor in the decline in economic activity that had occurred thus far.

Mr. Mitchell noted that the staff projections assumed that the oil embargo would not be lifted in 1974. In light of the recent international energy conference and other diplomatic efforts, he thought that assumption was becoming less realistic. He asked whether a resumption of Arab oil flows by, say, mid-year would change the economic outlook significantly.

Mr. Partee replied that the possibility of a resumption of the flow of oil from the Arab countries offered the main basis for thinking that the staff's projection might be too low. It seemed likely that the embargo would not be maintained throughout the year; it might be ended by mid-year, or perhaps even within a few weeks. But in addition to an end to the embargo, an increase in production by the Arab States also would be required. Before the start of the oil crisis, the United States had been counting on a very large increase in Saudi Arabian production, whereas at present Arab production was running a little below the pre-embargo rate.

It was not at all clear that the Arab countries would increase output sharply when the embargo ended. Indeed, it might well be in their long-run interest to hold production down while removing the embargo on exports to the United States. Without the embargo, the United States would be competing with Europe and Japan for the available supply of Arab oil, and the additional demand would help maintain the current high price of that oil.

Chairman Burns observed that much of the oil problem in the United States was attributable to an inefficient allocation system. Under the present system the independent companies that formerly imported oil no longer had any incentive to do so, since they could buy oil from the international companies at much lower prices.

Mr. Hayes remarked that there was evidence of both strong demand in the economy and widespread shortages of some materials, which were restricting production. It appeared that some of the shortages were the result of distortions caused by price controls. Since it now appeared that most of the controls would be lifted shortly, he suspected that such shortages would disappear rather quickly. He wondered if that would not tend to bolster the rate of growth of real GNP in 1974.

Mr. Partee said it was difficult to determine how important materials shortages had been in restraining the growth of output; he was not inclined to view them as a particularly critical factor at present. He noted in that connection that businesses were now able to build up their inventories. The book value of manufacturing and trade inventories rose at an annual rate of $32 billion in December, with manufacturing inventories showing particular strength. While the increase in inventories did reflect price rises to some extent, its magnitude implied a substantial increase in physical volume as well. Another possible indication of strength in inventory accumulation was the high volume of business loans at commercial banks in January.

With respect to Mr. Hayes' point about the relationship between price controls and shortages, Mr. Partee continued, it was significant that in a recent meeting with the Board some business economists who were knowledgeable about the petrochemical industry observed that shortages had disappeared in that industry after the termination of price controls. In industries where demand was strong, the lifting of controls and the consequent alleviation of shortages would lead to increases in output. However, in the present context of weakening demands in many industries, inventories could begin to appear excessive if the inventory build-up continued and prices started to soften, and there might be a sharper break in inventory accumulation in spring or early summer than was allowed for in the staff projections. Such a pattern had occurred in the past; and while he did not think the probability was high, it was a possibility.

Mr. Hayes then asked about staff expectations for agricultural prices, which seemed to be rising sharply again.

Mr. Partee observed that in the last few years forecasts in that area typically had been far off the mark. For what it was worth, the staff expected prices of agricultural products, especially meats, to continue rising through the spring and then to stabilize and perhaps even decline slightly over the second half of the year. Crop prospects for 1974 seemed to be good, and livestock marketings were expected to pick up sharply beginning in the late summer or early fall, because farmers had held back on shipments of meat animals to feedlots and had a surplus of overweight, grass-fed cattle on hand.

Mr. Hayes then noted that, while projections made by the staff at the Federal Reserve Bank of New York were similar to those made at the Board, they were a shade more optimistic about the likelihood of improvement in economic activity in the second half of the year. It seemed likely that inflation would continue at the current dangerous pace. He was more concerned about inflation than about the risks of a recession; a serious recession was as yet only one possibility on the economic horizon, and it perhaps was not the most likely possibility.

Mr. Clay commented that the current high rate of inflation could no longer be attributed mainly to special circumstances, such as the behavior of the energy and food components of the price index. Large increases were widespread; for example, prices of producer finished goods rose at an annual rate of 15.2 per cent in January, durable consumer goods were up 17.6 per cent, and other components increased at even faster rates.

Mr. Clay then referred to Mr. Partee's comment on the large stock of unsold new single-family homes and asked if information was available on the proportion of unsold homes that were located in outlying areas. Sales of such homes were undoubtedly being depressed by consumer concern about adequacy of transportation, and the housing demand situation could look quite different after builders had shifted their activity to more central locations. He also wondered about the proportion of housing construction accounted for by second homes, since buyers would no doubt be hesitant about acquiring second homes under current circumstances.

Mr. Partee replied that information was not available on the location of unsold houses within different parts of individual metropolitan areas. He might note, however, that representatives of the national home-builders' association reported there would be considerable delay--perhaps as much as several years--in making new central city housing available because of the necessity to obtain property for development, zoning exceptions, and so forth. With respect to Mr. Clay's other question, about 100,000 second homes had been constructed in 1973, but the staff projections allowed for only 50,000 units in 1974.

Mr. Clay said he had observed in recent years that even new townhouses and apartment houses were being located mainly in outlying areas. While it would undoubtedly be difficult for builders to obtain land in the central city for such developments and to induce buyers to return to the central city, the energy situation might well stimulate such a trend. That could be very significant for the housing industry.

Mr. Winn said he would like to make a few comments on the problems affecting the construction industry. It was his understanding that some banks recently had been withdrawing credit lines extended to real estate investment trusts--REIT's. Secondly, sharp rises in costs of labor and construction materials and in costs entailed in complying with stricter environmental standards--for example, with respect to sewers--were more important in disrupting builders' plans than was the current level of mortgage interest rates. The energy shortage was also causing utilities and fuel suppliers to refuse to accept new customers or to limit their number, thus adding to problems faced by builders.

The Chairman observed that zoning requirements were also severely restricting the volume of new construction in a number of metropolitan areas. He understood that the AFL-CIO had become seriously interested in that problem because of its potential impact on home building.

Mr. Coldwell remarked that some observers were also concerned about the effect of the Federal Reserve Board's Regulation T on the financing of condominiums.

The Chairman said that the Board would no doubt want to review that question.

Mr. Winn then commented that representatives of several large U.S. manufacturers had reported substantial price-cutting by Japanese firms with which they competed in world markets. If that practice were to spread, the competitive situation in world markets could change markedly. He also noted that U.S. firms with plants in Great Britain had had to make severe cutbacks in output because of the 3-day workweek.

Mr. Daane observed that British officials had estimated that, on the average, plant output in the United Kingdom was only about 70 per cent of normal and output of some firms was off 50 per cent.

Continuing, Mr. Winn remarked that some retailers felt that the January increase in retail sales reflected, to some extent, anticipatory buying by consumers concerned about potential price increases later in the year.

Mr. Winn then asked if the staff had calculated the cost of the provisions for retired workers--such as the cost of living escalator--in the aluminum industry wage settlement. Although the additional cost might not be so large for the aluminum companies because of their relatively small work force, similar contracts could prove very costly to manufacturing firms with large numbers of current and retired workers.

Mr. Mitchell observed that, unless the benefits were vested and the costs of the new provisions funded currently, the immediate outlay would be limited to the additional payments to the present retirees. The cost exposure would not be measured by the size of the present work force.

In conclusion, Mr. Winn noted that truck and rail tonnage in February was above the year-earlier levels, with the increases spread across most industries.

The Chairman remarked that those figures provided an independent indicator of the physical volume of production. At one time he had followed them closely; perhaps it would be worthwhile to review them again.

Mr. Daane said he had no reason to disagree with the staff's projection of economic activity. He asked whether Mr. Partee expected any slackening in the rate of inflation.

Mr. Partee replied that unit labor costs would probably continue to rise at a rate of 7 or 8 per cent in 1974. In the short run, the possibility that prices of raw materials and other goods sold in competitive markets would decline later in the year offered the only basis for hope in the price area; as to the longer run, in order to eliminate the roots of inflation it probably would be necessary to restrain the economy for 2 or 3 years. One had to face the question of how much restraint could be applied and for how long without precipitating stimulative policy actions.

In response to a further question from Mr. Daane, Mr. Partee said he did not share the fear felt by many of a self-feeding, accelerating inflation. He believed, however, that there would continue to be a high rate of residual inflation which could only be handled over a period of years.

Mr. Daane, noting that he had heard comments abroad about the possibility of negative real rates of interest, asked about the staff's outlook for interest rates.

Mr. Partee replied that, at current rates of inflation, short-term interest rates in most countries represented a negative real rate of interest; that implied higher interest rates, not necessarily this year, but in future years. There might be some upward pressure on long-term rates in the United States later in 1974 because of inflation, the large domestic demands for funds in capital markets, and the potential entrance of foreign borrowers in U.S. capital markets.

Mr. Balles noted that business capital spending had been a major element of strength in the economy. He asked if the staff had any indication of potential weakness in that sector.

In response, Mr. Partee said he thought it improbable that there would be a significant slowing in capital spending by the end of the year. There were no indications of cutbacks in capital spending plans. It was true that production of business equipment had leveled off, in fact edged downward somewhat, over the past 3 months; but that seemed attributable to supply shortages, not to deficiencies of demand, since unfilled orders remained strong. There was a decline in new orders for business equipment in December, but the index of new orders was volatile, and a one-month decline was not sufficient evidence of weakness.

Mr. Brimmer observed that perhaps it was time for the Committee to stop trying to determine the extent to which the current slowdown in economic activity was supply- or demand-induced and to focus instead on the consequences of the slowdown. Even with relatively optimistic assumptions, the staff was forecasting an unemployment rate of over 6 per cent by the end of 1974. Unemployment might prove to be even higher if weakness developed in any of the sectors which at present were exhibiting strength, such as plant and equipment spending.

It seemed to him, Mr. Brimmer continued, that in its policy deliberations today the Committee should concentrate on the appropriate trade-off between inflation and unemployment. Some members might believe that an unemployment rate in the neighborhood of 6 per cent was necessary--or tolerable if necessary--in order to dampen inflation; others might feel that such an unemployment rate was not acceptable, even though the inflation rate was in the neighborhood of 8 or 9 per cent. In his judgment, that question had to be confronted.

Chairman Burns said he might follow up Mr. Brimmer's comment with an observation he had intended to make at some point in today's discussion. As he saw it, the critical issue facing the Committee at this meeting was whether it intended to pursue the kind of monetary policy it had customarily resorted to in past periods of declining activity or whether, in view of the special characteristics of the current slowdown--particularly the rapid rate of inflation and the existence of shortages--it wished to pursue a more cautious policy during the early stages of this slowdown.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of System Open Market Account covering domestic open market operations for the period January 22 through February 13, 1974, and a supplemental report covering the period February 14 through 19, 1974. Copies of both reports have been placed in the files of the Committee.

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

> Short-term interest rates declined sharply over the period since the Committee last met as open market operations gradually supplied reserves more freely in response to indications that M_1 in the January-February period was falling short of the Committee's desires. By February 8, it appeared that M_1 was growing at an annual rate of only 1 to 1-1/2 per cent for the 2-month period, compared to the Committee's 3 to 6 per cent range. The Desk accordingly continued to strive for less stringent reserve conditions, expecting that the Federal funds rate would average around 9 per cent, down about 3/4 of 1 per cent from the rate prevailing just before the last Committee meeting. We did not press to the lower end of the 8-3/4 to 10 per cent range specified by the Committee because of the Treasury refunding, because M_2 was exhibiting considerable strength, and because there was a risk--in light of the already sharp decline in other interest rates--that overly buoyant market expectations might press rates to unsustainably low levels.

Last Friday, M_1 projections were revised sharply upward in light of the strong performance in early February, and the January-February growth rate now is expected to be about 4 per cent, which is well within the Committee's specified range. M_2 growth now appears to be above its 6 to 9 per cent range. Despite this apparent resurgence in growth of the aggregates, we made no change in our objectives with respect to day-to-day reserve and money market conditions in light of the proximity of this meeting of the Committee.

The decline in short-term interest rates was particularly sharp early in the period as market expectations were aroused by Desk actions that resulted in a progressive moderate decline in the Federal funds rate. In this atmosphere, the Treasury's refunding proceeded smothly. On February 6, Chairman Burns' statement indicating a need for a cautious monetary policy caused a temporary backing up of rates. In general, however, the market has been in a period of consolidation, with little change in rates in the past 2 weeks.

Last Friday's Treasury bill auction was representative of the short-term rate decline. Average rates of 7.02 and 6.79 per cent were established for 3- and 6-month bills, in each case down about 100 basis points from rates established just before the last meeting of the Committee. Similar declines were experienced in the commercial paper and CD markets, and as you know, the prime rate has come down 3/4 of 1 per cent to 9 per cent at most major banks. Intermediate rates have also declined--although by a lesser amount--despite the Treasury's issuance of $3-3/4 billion of such debt in its refunding. Long-term rates have also edged lower despite heavy calendars of corporate and municipal securities and a sale of $300 million of long-term bonds by the Treasury in its refunding. Dealer positions--particularly in the Government area--are high, but as yet there has been no tendency towards an aggressive effort to lighten holdings. Government dealers, in particular, are waiting for additional evidence of a further lessening of monetary restraint. If such signs are not forthcoming or are long delayed, rates could tend to back up, perhaps significantly. Corporate yields have already moved a bit higher in recent days as underwriter sales have lagged.

An important factor in the Treasury bill market has been the turnaround in foreign official activity since the ending of U.S. capital controls on January 29. Prior to that time, as you know, foreign central banks had been heavy sellers of Treasury bills. But with the weakening of the dollar in exchange markets after the termination of controls, they have become, on balance, modest net buyers.

As indicated by Messrs. Bryant and Coombs, the international situation that we are facing now could have profound effects on our money and capital markets. There are substantial opportunities for New York to increase its role as a center of international finance, and the market is currently trying to work out what it all may mean. There is a general expectation of increased foreign demand in both our money and capital markets and particularly the latter. This demand--coupled with expectations of continued domestic inflation--is expected to exert upward pressure on long-term rates. Whether or not U.S. financial institutions will be as successful in attracting capital from abroad, particularly from oil-producing countries, as they expect to be in expanding loans abroad is less clear. The net result, however, is of vital importance for our balance of payments and for the foreign exchange markets. It seems to me that the closer integration of our money and capital markets with those abroad is a matter that we will have to follow very closely in the months ahead.

I should add that the Treasury expects to announce this week its plans to raise about $2 billion of new cash by early March. The terms of the offering have not yet been decided, but it should be a relatively routine operation.

Finally, as mentioned in one of the weekly written reports to the Committee, Lehman Government Securities, Incorporated, decided to discontinue its activity in the Government market, and we accordingly discontinued our trading relationship with that firm on January 28. On the other hand, several other firms are eager to establish themselves as dealers and are in the process of demonstrating to us their market-making ability.

Chairman Burns asked Mr. Holmes to comment on the tests he applied to Government securities dealers with whom he contemplated establishing a trading relationship.

Mr. Holmes responded that a dealer would need to have adequate capital and would need to have demonstrated his capacity to make a market. As a rough minimum requirement, the dealer's transactions ought to account for about 1 per cent of the market's volume.

Mr. Eastburn asked how the market might react to a reduction of 1/4 of 1 per cent in the discount rate.

Mr. Holmes replied that such a reduction would confirm dealers' expectations concerning monetary policy, with the result that short-term interest rates would decline further.

Mr. Mitchell asked whether aggressive System operations had been needed in order to achieve the desired growth in reserves over the past month and how the market had interpreted System operations.

In response, Mr. Holmes observed that the projections presented at the time of the January meeting of the Committee had indicated that market factors would provide all of the reserves needed, but in fact the System had had to provide some reserves. Although aggressive action had not been necessary, the Desk had provided reserves to the market at progressively lower funds rates. Market participants, who had been watching for such intervention by the Desk, considered those operations significant, and a general decline in short-term interest rates ensued. Although the easing in the money market had been moderate rather than spectacular, dealers hoped that the System would ease further and that they would be able to sell at a profit the large inventories of securities that they had accumulated.

Chairman Burns asked Mr. Holmes for his judgment about the probable behavior of short-term rates in general over the recent period if Desk operations had been directed toward maintaining approximate stability in the funds rate.

Mr. Holmes said short-term market rates either would have been stable or would have risen somewhat. Desk operations were largely responsible for the decline in short-term rates, although cessation of sales of Treasury bills by foreign monetary authorities had been an important factor in the bill market.

In reply to additional questions from Chairman Burns, Mr. Holmes observed that in his judgment the general decline in short-term rates had been larger than warranted by System operations, but such a reaction usually occurred when the market came to expect further easing actions on the part of the System. At the present time, Government securities dealers had such expectations. They had not been trying aggressively to unload their large inventories but were waiting in the hope that the funds rate and short-term rates in general would decline a little further.

Mr. Mitchell asked what forces were holding the Federal funds rate so much above the Treasury bill rate.

Mr. Holmes responded that strong demands for liquidity in general had an important influence on the bill rate and thus on the rate relationship between bills and Federal funds. Although the existing relationship had prevailed for some time, it was unusual and could not last indefinitely. Dealers were financing their inventories of bills, which were yielding about 7 per cent, by borrowing at rates of 8-1/2 and 9 per cent. Thus, they were incurring losses in carrying inventories while waiting for prices to rise further.

In response to a question by Chairman Burns, Mr. Holmes commented that banks in general were not sellers of Treasury bills in this period because they held few bills that were not in some way tied up as collateral.

Mr. Holland asked whether it was not fair to say that some commercial banks, like Government securities dealers, preferred borrowing at very short term, in the funds market, to borrowing at somewhat longer term.

Mr. Holmes agreed that bankers had such a preference because they also expected rates to decline further.

Mr. Mitchell asked what effect might be produced by reducing the minimum term for certificates of deposit from 30 days to, perhaps, 10 days.

Mr. Holmes responded that a reduction in the minimum term would provide U.S. banks with a better opportunity to compete with banks abroad for short-term funds. Thus, it probably would have greater implications for international than for domestic flows of funds.

In response to additional questions, Mr. Holmes observed that in talking with commercial and investment bankers he had been impressed with their current efforts to make loans abroad. They were paying much less attention to attracting deposits from abroad. Therefore, the danger existed that foreign loans would be financed from domestic sources of funds, thus having an adverse impact on the U.S. balance of payments and on domestic interest rates. The underwriters with whom he had talked hoped to place some longer-term bonds with Arab countries, but they did not expect the volume of such placements to be great. Such bonds might have maturities in the intermediate range and bear interest of 8 to 8-1/2 per cent.

Mr. Daane observed that the Arabs might be concerned about the possibility that funds placed directly in the United States would be blocked.

Chairman Burns remarked that the funds could be placed in the United States indirectly through Switzerland.

Mr. Mitchell commented that the economic effects for the United States were the same whether the funds were placed in this country directly, or indirectly through Switzerland.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 22 through February 19, 1974, were approved, ratified, and confirmed.

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

> The alternatives[1/] presented for Committee consideration at this meeting imply a lower level of interest rates than was contemplated at the previous meeting for a given rate of growth in the aggregates. This reflects basically the further weakening in economic activity projected for the current quarter.
>
> Short-term rates have already declined considerably since the last meeting, however. Thus, little or no further decline seems needed to attain the monetary aggregates outlined under alternative B--

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

which includes the 5-3/4 per cent M_1 growth adopted at the last meeting for the first 6 months of this year.

I should note for the Committee some of the background to such a judgment by the staff. Of the three econometric models we looked at, one suggested some rise in interest rates, one no change, and the other some further decline. Of the two purely judgmental forecasts of monetary relationships, each would have suggested a decline in rates before the latest week's data on the monetary aggregates were available. It turned out that these data--though preliminary and subject to revision--were so strong that the judgmental projections of the aggregates, for given interest rates, were raised substantially. Judgmental projections are quite sensitive to incoming data--which is their strength, but which also can be their weakness in a highly volatile situation.

M_1 has shown sizable month-to-month swings recently, with a decline in the average outstanding money stock in January likely to be followed by a sharp rise in February. To some degree, this may represent a normal averaging-out process. In addition, we have experienced a very large decline in U.S. Government deposits during the first half of February. This could lead to enough of a temporary transfer of funds into private demand deposits to affect our monthly averages for M_1. In the past we have not found any very dependable correlation between Government deposits and M_1, but the recent decline in Government deposits has been so large as to enhance belief in that possibility this time.

While there is legitimate doubt as to the basic strength of M_1, the underlying strength of expansion in M_2 seems reasonably clear. Time deposits other than large CD's at banks appear to be growing at a faster pace this quarter than even in the final months of last year. This has led us to raise the rate of growth in M_2, as compared with expectations at the time of the previous Committee meeting.

Interpretation of the strength in M_2 does, of course, pose a policy problem for the Committee. The strength of M_2 (and also M_3) does not on the face of it appear to represent a greater propensity to save in general on the part of the public since the personal saving rate is projected to drop between the fourth and first quarters. To some degree it no doubt reflects the lower market rates of interest, which make time deposits a relatively more attractive outlet for savings. In addition, though, I would argue that there has been some diversion of savings from equities and other market instruments to less risky forms in this period, because job prospects are uncertain and, therefore, the need for more readily spendable savings is greater.

Thus, we may be seeing expansion of M_2 in reflection of economic weakness. To that extent, the Committee may wish to accommodate the expansion, at least for a while. If the economy does turn weaker than expected, this liquidity may be used to cushion declines in economic activity. On the other hand, if the economy turns up and incomes are maintained, the funds may move back into other higher earning financial assets and not directly into the spending stream--although there is the obvious risk that the funds would be used directly in spending and enhance inflationary pressures.

The uncertainty as to the fundamental strength of M_1 and the difficulty in interpreting M_2 would suggest that the Committee may wish to consider leaving itself the option of either easing or tightening the money market somewhat in the weeks ahead. Any move toward the tightening side could well cause sizable upward interest rate adjustments, at least temporarily, because it would be unexpected by market participants and would come when there is a large overhang of securities in the market--from the recent Treasury refunding, the small cash financing to be announced in a day or two, and the very sizable volume of corporate and municipal bond offerings in process. On the other hand, a further easing of the money market would be about in line with market expectations, with some easing to a degree already discounted by the market.

Chairman Burns observed that the Committee was ready for its deliberations concerning monetary policy. As he had suggested earlier, the critical question was whether the Committee should conduct policy in the classical fashion, in view of the recent declines in production and employment and the prospects that the declines would be extended for some months, or whether it should pursue a more cautious policy because of the special characteristics of the current economic slowdown or recession--notably, the rapid rate of inflation and the shortages of fuel and other basic materials.

Mr. Francis said he believed that the over-all economic situation was stronger than suggested by the green book projections and, consequently, that there was a risk of more upward pressure on short-term interest rates this spring as a result of greater expansion in credit demand than implied in the blue book.[1/] In addition, as a result of a market over-reaction to recent decreases in the Federal funds rate, short-term rates probably were temporarily lower than would be consistent with basic market factors. Should an attempt be made to hold the Federal funds rate at about its recent level, growth in the monetary base would be rapid. Estimates made at the St. Louis Bank suggested that the growth of the base, along with the projected decrease in Treasury deposits, would be such that M_1 would expand at a rapid rate--somewhere between 6.5 and 7.5 per cent--in the first half of 1974.

Mr. Francis observed that he continued to feel that inflation was the major long-term economic problem. If any progress was

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

to be made against inflation, the average growth of the money stock would have to be reduced below the 7 per cent rate experienced over the period from early 1970 to mid-1973. In the last two quarters some progress in reducing this trend rate had been made. However, to reduce the rate from 7 to 6 per cent by the end of 1974 required a continued restraint on money growth similar to that experienced over the last two quarters of 1973.

With regard to the specifications, Mr. Francis said, he could not accept those of either alternative A or B. Although the growth rate of M_1 in alternative C appeared to be on the high side, he could accept that alternative provided that the Federal funds rate was permitted to move freely within the 8-3/4 to 10 per cent range during the next 4 weeks. However, he would prefer the language of alternative B--that is, to call for "moderate" rather than "quite moderate" growth in monetary aggregates.

Mr. Black remarked that ordinarily he would place major emphasis on the behavior of the aggregates, but in this period he would temporarily give more weight to money market conditions. In the present circumstances, the Committee might under-estimate the impact of inflation on transactions demands for money, and money supply might grow at a faster pace than projected unless interest rates were allowed to move back up. With unemployment and prices rising, a significant back-up in the Federal funds rate could produce something close to a crisis in financial markets. Therefore, it was important for the System to attempt to assure the market that the necessary liquidity would be provided. In the period immediately ahead, consequently, he would not allow short-term interest rates to back up and would be inclined to let the Federal funds rate drift down within the framework of the alternative B specifications. While holding to the longer-run targets of alternative B, he would raise the upper limit for the February-March range of tolerance for M_1 to 10 per cent--which might result in a 5-1/2 per cent rate of growth over the first quarter--and would put a ceiling of 9-1/4 per cent on the funds rate. He favored the language of alternative B.

Mr. Hayes remarked that he agreed with Chairman Burns' assessment of the problem confronting the Committee, and he favored the cautious approach to policy. Although an unemployment rate averaging around 5-3/4 per cent in 1974 was not a pleasing prospect, the amount of unemployment in excess of 5 per cent--the figure now widely accepted as a fair approximation of reasonably full employment--did not justify a decisive move toward ease to counter the modest slackening in business activity in prospect. Selective fiscal policy actions would seem to be more effective in dealing with unemployment, and the Federal budget was likely to be reasonably stimulative.

Unfortunately, however, market participants believed that they were beginning to see a decisive, clear-cut pattern of ease in Federal Reserve policies. Although Chairman Burns' remarks at a recent Congressional hearing had been helpful in checking that market view, the rate of decline in the funds rate and in other short-term interest rates had been a powerful factor in sustaining an impression of policy easing.

Continuing, Mr. Hayes observed that in view of the apparent strength in M_1 in February, the Committee could have a more relaxed attitude toward the January decline. In January vast amounts of credit had been extended in the bond market, in the commercial paper market, and by the commercial banks, and those large credit demands had been satisfied at declining interest rates. The recent record of flows into the thrift institutions did not suggest a need for much concern over disintermediation or the availability of mortgage funds.

With respect to international developments, Mr. Hayes commented that the dollar had tended to weaken because of a somewhat less grave oil situation than had been originally expected, the removal or reduction of capital controls in the United States and Europe, and the visible signs of easing of U.S. monetary policy. In view of the great importance of maintaining confidence in the dollar, those circumstances--together with the prospect of vastly increased international flows of funds arising from the energy situation--pointed up the need for great caution in moving toward ease.

In conclusion, Mr. Hayes said his prescription for policy would be to maintain existing money market conditions, with a range for the funds rate centered on 9 per cent and extending symmetrically from 8-1/2 to 9-1/2 per cent. Hopefully, that would be consistent with a 6-month growth rate for M_1 well short of 5-3/4 per cent and preferably closer to 5-1/4 per cent. With respect to the February-March ranges of tolerance for the aggregates, even the specifications of alternative C seemed excessive; he hoped that the current funds rate would be consistent with a range of 4 to 8 per cent for M_1 in the 2-month period. Alternative B language for the directive--which was the same as that adopted at the January meeting--was acceptable, although he would prefer a directive that called for maintaining current money market conditions.

Mr. Eastburn said it was important to remember that the aggregates had been growing at rates that were high historically, which had a bearing on the rate of inflation. It would be desirable to reduce the rate of monetary growth over the longer run. Therefore, his answer to the difficult question posed by the Chairman in essence was that the longer-run growth path of 5-3/4 per cent for M_1 as specified under alternative B was appropriate. To foster that objective, he would widen the short-run ranges for both M_1 and the funds rate. Specifically, he would establish ranges of 7-1/2 to 10 per cent for M_1 and 8 to 9-1/2 per cent for the funds rate.

Mr. Bucher--noting Mr. Brimmer's earlier remarks on the need to weigh the trade-off between unemployment and price objectives in the formulation of policy--observed that it was important also to consider the trade-off which the Congress might consider appropriate. Although many people now regarded a rate of unemployment in excess of 4 per cent as acceptable, he was not convinced that Congress as a whole was prepared to accept a rate as high as 5 per cent; certainly, it would not find a 6 per cent rate acceptable. Committee members needed to be concerned about the effects that System policies might have on Congressional actions to deal with high unemployment and to recognize that, in the long run, the adverse effects of such actions on prices could be much greater than those of any marginal measures the System might take at this point.

Continuing, Mr. Bucher remarked that he particularly wanted to keep interest rates from backing up; a reversal of the downward trend in rates would be counter-productive and debilitating. Apart from aiming to prevent an excessive weakening in aggregate demand, monetary policy could accomplish little in the short run, but it should result in some further decline in market interest rates. As consumer and business uncertainties were dispelled with time, somewhat lower interest rates could prove most important in assuring that financial conditions by spring or early summer would be conducive to a rebound in housing activity during the second half of the year. A further lowering of short-term rates would encourage a decline in long-term rates, exerting downward pressure on mortgage rates. As mentioned earlier in the discussion, a number of States still had usury ceilings that constrained potential mortgage lenders, and in those instances a rather small easing in market rates could be most productive.

In addition, Mr. Bucher observed, a further decline in short-term market rates would further improve the flow of funds to the thrift institutions. Although there had been some improvement in those flows--at the savings and loan associations more than at the mutual savings banks--it appeared that in many cases the savings and loan associations recently had used the funds to pay off loans and rebuild liquidity. Finally, a further decline in the funds rate would induce some savings and loan associations to shift funds out of Federal funds and into mortgages.

In any event, Mr. Bucher remarked, it was quite important to enter the spring and early summer months with an improved housing finance environment. That was the period when there usually was a strong seasonal upturn in housing construction and also a rise in consumer interest in housing. In his view, at the margin, somewhat larger mortgage credit supplies and lower rates of interest would be more constructive than harmful.

With respect to policy, Mr. Bucher observed that, because of his desire to avoid a backing-up of interest rates, he would make clear to the Desk that the funds rate should decline further. He could accept a funds rate range of 8 to 9 per cent, which was between alternatives A and B. The related figure for M_1 growth in the first half of the year--he had been informed by Mr. Axilrod--would be 6 or 6-1/8 per cent; specifications for the other aggregates also would fall between those of alternatives A and B. For the language of the directive, he preferred alternative A.

Chairman Burns remarked that at this point he would read a few paragraphs from a draft of the statement that he would present before the House Appropriations Committee on the following day.

> Since strong inflationary forces are likely to continue in 1974, even in the face of declines in production and employment, public policy is now clearly confronted with a most difficult problem.
> Inflation cannot be halted this year. But we can move resolutely to establish this year a dependable framework for a gradual return to reasonable price stability. . ..

> In the current economic slowdown, the task of monetary policy will not be the same as in a classical business recession, when a considerable easing in the supply of money and credit can be expected to provide the financial basis for the subsequent recovery. This year, our nation's capacity to produce may actually decline, or at best rise at an abnormally low rate. A great deal of caution will therefore be needed in framing monetary policy. An easier monetary policy can be only a marginally constructive influence when economic activity slows because of a shortage of oil.
>
> Fiscal policy can be used to better advantage than monetary policy in promoting prompt recovery in this kind of economic environment. Selective measures such as an expanded public employment program, increased unemployment benefits, or some liberalization of welfare payments in hard-hit areas may be needed to cushion the adjustment to fuel shortages. Also, a selective tax policy of accelerated amortization could stimulate invstment in the energy and other basic materials industries, thereby relieving the more critical shortages of capacity that have recently proved so troublesome.
> investment in the energy and other basic materials industries, thereby relieving the more critical shortages of capacity that have recently proved so troublesome.
>
> Current economic conditions may therefore justify special fiscal measures of the kind I have mentioned. But I would strongly advise against adoption of a generally stimulative fiscal policy, such as a broad tax cut or substantially enlarged expenditures. It is not clear that a strong dose of fiscal stimulus is needed now, and we surely need to proceed cautiously at a time when the price level is still soaring. Let me remind you that last month alone the wholesale price level rose over 3 per cent. . ..
>
> An overly expansive fiscal policy now would delay, perhaps delay for many years, the progress which the Congress has been seeking in the use of the Federal budget as a tool of economic stabilization. . ..

Chairman Burns added that during the preceding month the drop in short-term interest rates had been sizable; in his judgment it had been larger than that contemplated by Committee members in their policy deliberations at the January meeting. The market now was anticipating a further easing promptly after this meeting. He thought it would be a great mistake to confirm that market view at this time. The Committee should proceed cautiously. Increases in prices were widespread, and as Mr. Clay had pointed out, the inflation could not be attributed just to advances in prices of foodstuffs and fuels. Production and employment had declined in large part because of shortages of materials and component parts; the evidence did not yet suggest that there was a general deficiency of demand. The BLS establishment survey indicated that nonfarm employment had declined about 300,000 from November to January. According to the Census series--which was less reliable in the short run--nonagricultural employment dropped by about 175,000 between October and January; however, total employment was unchanged in November, rose 20,000 in December, and rose 140,000 further in January. It is also reported that from the beginning of December to early February, gross layoffs attributable to the energy shortage amounted to about 340,000.

Mr. Mitchell commented that monetary policy in the last couple of months had not followed the traditional pattern. Had the Committee wished to follow such a pattern in response to the weakness in industrial production and real retail sales, it should have made a stronger move before this time. However, he was satisfied with the course that the Committee had pursued, because it had accomplished the important objective of halting disintermediation. At current levels of interest rates, disintermediation was no longer a threat.

Mr. Mitchell observed that while there was general agreement that the dislocations resulting from the oil shortage could not be cured by monetary policy, the secondary effects of those dislocations could be influenced by actions of the System. However, he hesitated to take any such actions at this time--among other reasons, because of the abnormal behavior of prices, which had to be given more than the usual consideration, and because of the artificial assumption about oil supplies underlying the staff GNP projection. Like Messrs. Holmes and Coombs, moreover, he was especially worried about the international flows of funds that were likely to occur during the months ahead. Those flows were particularly disturbing because the Committee might attach great weight to the behavior of M_1 in its policy formation when the behavior of M_1 would have nothing to do with the real problem. Thus he was concerned about the problems that the Committee would face at the next few meetings, because policy in pursuit of domestic objectives might be seriously jeopardized by the international flows. All of this was, he believed, another way of saying what the Chairman had said, and it led him to conclude that something close to the prescription of alternative B was appropriate.

Mr. Mayo remarked that 1974 would be a frustrating year with respect to behavior of both unemployment and prices. He was not convinced that economic activity would turn up in the second half of the year to the degree suggested by the staff projections, and he anticipated that the unemployment rate would not be held below 6 per cent. At the same time, he saw no way to make significant progress this year in reducing the rate of inflation below 6 per cent. Projections of prices made at the Chicago Bank based on alternative assumptions of M_1 growth rates--6 and 8 per cent for this year and next, 7 per cent for both years, and 8 per cent for both years--did not differ greatly from one another until late in 1975 but under the more restrictive policy assumptions, the unemployment rate projections suggested too high a cost for a faster diminution in the rate of inflation. He believed, therefore, that the Committee ought to look beyond 1974 and try to establish a sound base for economic recovery in 1975.

Mr. Mayo said he agreed with the need for caution, but that led him to prescribe a slightly easier policy--or a policy of milder restraint--in order to lay the proper base for next year. His prescription, therefore, was a little closer to alternative A than B. An M_1 target of 5-3/4 per cent for the first half of this year--as specified under alternative B--was a little too restrictive in an environment in which the GNP deflator was expected to rise at an annual rate of 7.5 per cent. He favored a target of 6 per cent, which would still be less than the projected rate of price increase, and would even consider a 6-1/4 per cent target. He agreed with those who would widen the short-run ranges of tolerance, because the statistics were so erratic. He would specify a range of 7-1/4 to 10-1/4 per cent for M_1, 10 to 13 per cent for M_2, and 4-1/2 to 7-1/2 per cent for RPD's--in effect, encompassing the short-run ranges of alternatives A and B. For the funds rate, he would specify a range of 8 to 9-1/4 per cent.

Mr. MacLaury observed that he was much in sympathy with Mr. Mayo's policy prescription. While the question of whether or not to respond to the present situation in classical fashion was an important one, the responses might tend to exaggerate the differences in members' views with respect to specific policy preferences. In his view, slack demands rather than supply constraints were the dominating force in the situation, but nevertheless, his policy prescription was not far from one that could be described as cautious and moderate. Monetary policy could not do much to inhibit the demands for wage increases this year that would be based in part on the rise in prices that had already occurred. At the same time, the strength of the upturn in activity in the second half of the year was in question, and like Mr. Partee, he believed that the risks were greater that the staff projections would prove to be too high than too low. The inventory build-up was likely to slow in the second half, and the expansion in residential construction might not be as great as suggested by the staff projections. Moreover, uncertainty was a key element leading to cautious behavior on the part of consumers, and there was some risk that the System would increase uncertainty if it did not follow what was generally regarded as a classical policy. And like Mr. Bucher, he believed that if the Committee did not continue to pursue a modest easing in policy, other agencies of government might take actions that the members would like less than any they would be inclined to take themselves.

Against that background, Mr. MacLaury said, he continued to favor a long-run M_1 path of 6 per cent, rather than 5-3/4 per cent. On general principles as well as because of the present circumstances, he would widen the range for the funds rate, specifying 8 to 9-1/2 per cent. Whether or not the rate was moved down within that range ought to depend on the week-by-week assessment of the behavior of the aggregates.

Chairman Burns noted that this was the last meeting that Mr. Daane would attend as a Committee member, and that a luncheon in his honor was planned for today. He suggested that Mr. Daane be given an opportunity to express his policy views before the Committee recessed for luncheon.

Mr. Daane remarked that, like former Chairman Martin at his last Committee meeting, he was discouraged that the System had made so little progress in the battle against inflation. However, he felt that the System could not do more than it had been doing--that it had done about as well as it could in a difficult period.

With respect to the Chairman's question, Mr. Daane said it would be unwise to resort to a classical policy, that a cautious approach was to be preferred. He had always been inclined to emphasize the significance of expectations, and he would not want to give signals at this juncture that would tend to confirm market expectations of a further easing in policy. At the same time, he would strongly resist a backing up of short-term rates, which would be interpreted as a signal of tightening and would provoke a significant upward movement in long-term rates. Once again, this was a time for a steady policy, in recognition that the Committee could not solve all of the problems. He would have the Committee issue a directive that said either ". . .the Committee seeks to maintain about the prevailing money market conditions, provided that the monetary aggregates appear to be growing at rates within the specified ranges of tolerance" or ". . .the Committee seeks to maintain prevailing bank reserve and money market conditions consistent with moderate growth in monetary aggregates." He preferred the latter alternative.

Thereupon the meeting recessed until 2:55 p.m. Committee attendance was the same as at the morning session. Staff attendance was the same as at the morning session except that Mr. Hocter was absent.

Mr. Morris commented that he differed with the Chairman's assessment of the economic situation and, therefore, had a different policy prescription. In his view, weakness in consumer demand was becoming the predominant force in the economy. Moreover, the decline in activity in the United States was going to be accompanied by declines in the rest of the world, and just as the world-wide boom in 1973 had had a major impact on developments in this country, so also would the world-wide decline in activity. Therefore, prudence called for leaning against the wind of a weakening in demands and for moving a little more aggressively in the direction of monetary expansion. Later on, should it become apparent that the third-quarter upturn in real GNP was in fact developing, the Committee could alter the course of monetary policy. Accordingly, he favored alternative A. While he did not have major objections to the longer-run targets of alternative B, he seriously questioned whether they could be attained under the pattern of interest rates associated with that alternative.

Continuing, Mr. Morris said he agreed that the Committee should proceed cautiously, as it had been doing. Although growth in M_1 had been strong in the 2 weeks through February 13, he was inclined to discount the strength on the grounds that Treasury balances had declined about $3 billion during the period; moreover, the figure for the latest week was still subject to revision. Thus, it would be premature to project strong growth in M_1. Taking January and February together, M_1 was growing at a rate of 4 per cent, and over the 6 months through January, it had grown at a rate of only 2.5 per cent. To be sure, short-term interest rates had fallen about 200 basis points from their peaks, but the yield curve was still very flat. The curve did not exert pressure on portfolio managers to stretch out their portfolios into longer maturities; it allowed them to stay in the safe haven of short-term securities without any significant sacrifice in yield. As long as the yield curve remained flat, recovery in the mortgage market would remain slow. In his view, a policy that resulted in stable interest rates would be too cautious for the present state of the economy. Thus, he favored the short-term specifications of alternative A, which included a range of 7-1/2 to 8-3/4 per cent for the funds rate. With that range, the Manager would be required immediately to make a modest downward move in the funds rate--as he had been required to do just after the January meeting--carrying the funds rate down into the 8-1/2 to 8-3/4 per cent area.

Mr. Coldwell said he still believed that inflation was the country's primary problem. He had not seen convincing evidence of a consumer demand recession, and a deep recession was unlikely to develop unless it grew out of an international problem. To those who worried about the financial conditions in the housing area, he would point out that building costs were very high, and an increase in the availability of funds could not remedy that problem.

Mr. Coldwell observed that he favored alternative C in order to avoid aggravating inflation. Although the 6-month target specified for M_1 was 5 per cent, he would be reasonably satisfied if the rate of growth actually proved to be 5-1/2 per cent; he was concerned that if the Committee adopted a target of 5-3/4 per cent or of 6 to 6-1/2 per cent, the actual rate would be, respectively, 6 or 7 per cent. He would like to see the funds rate held within a band of 9 to 9-1/4 per cent or 8-3/4 to

9-1/4 per cent, although it might be necessary to specify a wider range. He would avoid leading market participants to expect further easing in money market conditions; they were poised to respond to an immediate easing in the funds rate and to push market rates down further. The possibility of an easing in fiscal policy provided an opportunity for the System to ease monetary policy less than it otherwise might. With respect to the language of the directive, he would prefer calling for "modest growth" rather than "quite moderate growth." He asked Mr. Holmes whether the forthcoming Treasury financing was of sufficient importance to warrant a reference in the directive.

Mr. Holmes replied that he expected a routine financing operation. He doubted that it had to be mentioned explicitly in the directive, although it was a market factor that the Desk would need to watch.

Mr. Holland remarked that, in view of the special characteristics plaguing this economic slowdown, it would be wise to pursue a cautious approach to actions affecting the behavior of interest rates and the aggregates. He would be wary and slow in promoting the kind of financial conditions that would stimulate large-scale shifts of productive resources--including labor--into new activitities in response to the supply-induced dislocations; the national interest would be better served if those resources remained available where they were for a time in the event that some of the supply bottlenecks could be broken.

Consequently, Mr. Holland said, he favored alternative B. The longer-run M_1 target of 5-3/4 per cent specified under that alternative was high enough, and the projected rates of growth in M_2 and M_3--although resulting in part from defensive reactions to the economic situation--would provide ample financing for the kinds of expenditures that were being counted on to produce an upturn in economic activity in the second half of the year. Within the framework of alternative B, the Desk should be slow to move the funds rate in either direction. Thus, he would avoid a runup in the funds rate that, in the sensitive state of the market at present, would provoke a general increase in interest rates. And in the event that developments indicated a need for easing action, he would prefer--as he had suggested at the January meeting--that the Manager notify the Chairman so that the Board would have the opportunity of considering a reduction in reserve requirements as an alternative to further easing through open market operations.

Mr. Kimbrel commented that while there were signs of economic weakness in his own District, businessmen repeatedly indicated surprise that the situation was not worse. Even in Florida, one heard the view that after a period of over-building, the economy was passing through a catching up phase that would have occurred even in the absence of the energy crisis. As the Chairman had indicated, the present situation was marked by such special circumstances as shortages and rapid inflation. In addition, increasing deliquencies in repayments of credit were a source of concern, and it would be desirable to have a period of cleaning up those outstanding credits. While no one wished to contemplate the prospect of rising unemployment, a moderate increase had to be tolerated in the present circumstances in order to make progress in controlling inflation.

Concerning policy, Mr. Kimbrel said this was a time to deviate from a classical stance and to adopt a more cautious approach. In that light, he wondered how long the money supply could grow at a rate of 5-3/4 per cent before one could no longer reasonably describe policy as cautious. He would refrain from encouraging the market to believe that the System was going to pursue ease progressively. He preferred the specifications of alternative C. And he hoped that the funds rate could be held close to its recent level, within a range of 8-1/2 to 9-1/2 per cent.

Chairman Burns remarked that it might be helpful if the Committee's Senior Economist gave his policy recommendations at this point.

Mr. Partee said he wished to remind Committee members that the staff projections for this year--incorporating as they did the Committee's longer-run monetary growth targets--indicated that the unemployment rate would rise to a point that was rather high historically. Thus, the projections already reflected the Committee's considerable concern with reducing inflationary pressures; the projections implied a trade-off between the objectives for the unemployment rate and prices that the Government in general, and the Committee in particular, would not have felt comfortable with in earlier periods. The pattern of interest rates underlying the projections was believed to be consistent with growth in the money supply at a rate of 5-3/4 per cent. In considering the Committee's posture, therefore, the members ought to take into account the fact that the 5-3/4 per cent growth would not, in the staff's view, produce a downturn in the unemployment rate this year. Also, the staff believed that the current level of interest rates was consistent with the 5-3/4 per cent rate of growth in M_1, which, if so, suggested that no further significant declines in short-term rates should be needed.

Mr. Balles commented that he favored a cautious policy at this time, rather than a classical policy of easing in the face of weakness in the economy. He believed that the weakness apparent in December and January was induced mainly--although not entirely--by supply problems and that easing policy now would aggravate inflationary pressures in the longer run. As Mr. Brimmer had said, Committee members had to make a judgment on the issue of the trade-off between unemployment and inflation. Although knowledge of monetary policy lags was limited, it seemed to be a widely accepted proposition that the lags were longer for the price effects than for the output and employment effects. Accordingly, the Committee might be able to achieve its objectives for employment in the short run at the cost of aggravating inflationary pressures in the longer run; and the improvement in the employment situation would not be permanent. In addition, fiscal policy was likely to be more stimulative than official projections suggested--a prospect that was underscored right after the budget was announced when Mr. Malek, the Deputy Director of the Office of Management and Budget, said the Administration would "bust the budget" if necessary to combat rising unemployment in a recession.

Concerning specifications, Mr. Balles said alternative B came closest to meeting his desires. On a quarterly average-basis, growth in M_1 from the fourth quarter of 1973 to the second quarter of 1974 would be at a rate of about 6 per cent--approximately the same as the rate of growth from the fourth quarter of 1972 to the fourth quarter of 1973. Alternative B did not represent an especially restrictive policy; in fact, it might be viewed as expansive in light of the reduction in potential growth in real GNP that had been brought about by the energy shortage.

In conclusion, Mr. Balles observed that the System might experience difficulty in preventing monetary growth rates from overshooting the targets of alternative B. The large increase in the monetary base in the period from September to January--at an annual rate of nearly 10 per cent--could lead to a higher rate of monetary growth than that projected by the staff. In addition, there had been a systematic tendency in recent years for deposits to rise more rapidly at nonmember banks than at member banks. Thus, several biases might be working toward higher-than-projected rates of monetary growth; as a result, M_1 might grow at a rate in excess of 5-3/4 per cent over the first half of this year, which would be overly stimulative. Accordingly, any shading of the short-run ranges of tolerance for the aggregates ought to be in the direction of alternative C, and for the February-March period, it would be desirable to hold the rate of growth in M_1 within the range of 6-3/4 to 8-3/4 per cent.

Mr. Brimmer said his own attitude toward the question he had raised earlier concerning the appropriate trade-off between the employment and price goals led him to favor the policy approach that the Chairman had described as cautious. Since the January meeting short-term interest rates had in fact declined more than anticipated by some members of the Committee, and he saw no need to press on from the present position. Accordingly, he would accept alternative B. However, he was not locking himself in and would want to reconsider his position in the event that by the next meeting a more traditional type of recession appeared to be developing.

Mr Sheehan remarked that he agreed with the views expressed by both Mr. Morris and Mr. Brimmer, although that might appear to be difficult. He shared the view Mr. Black had expressed that it would be better at this time to give increased weight to money market conditions, and he had been impressed by the remarks of Messrs. Mayo, MacLaury, and Morris. In particular, he agreed with Mr. Morris' evaluation that the downturn in economic activity was not primarily supply induced; as he had argued at the January meeting, the weakness had become more general. He still held the views he had expressed at that meeting, and he would not take the time to repeat them now but would add just a few thoughts. He was more pessimistic about the economic outlook than other members of the Committee and the staff, and he was so in large part because of the extreme weakness in consumer confidence. Consumers were especially concerned about inflation, and since the late 1960's they had had a growing feeling that government lacked the ability to control it. Such feelings were being exacerbated now by rising unemployment and by the Watergate matter. As Chairman Burns had remarked recently, when economic activity was in recession, no one could forecast how deep the recession would be or when activity would turn around. Personally, he could not foresee the turnaround and had little confidence that growth in real output would be resumed in the third quarter.

With respect to the question posed by the Chairman, Mr. Sheehan commented that inflation certainly was the country's most important problem. As he had remarked at the January meeting, however, a recession in activity with an unemployment rate in the neighborhood of 6 per cent would not affect the rate of inflation much, if at all--any more than it had in the 1969-70 period. Nevertheless, he agreed with the Chairman that policy should proceed cautiously. As Mr. Brimmer had noted, there had been a substantial easing in short-term rates since the last meeting. While he had favored an easier policy and had been pleased by the declines in rates, he believed that policy movements should proceed smoothly when possible. Therefore, like Mr. Brimmer, he would be satisfied to wait until the next meeting to determine whether another significant policy move was called for.

Specifically, Mr. Sheehan said, he favored the longer-run targets of alternative A and the short-run ranges of tolerance for the aggregates of alternative B, leaning toward those of A. He would set the lower limit for the funds rate at 8 per cent rather than 8-1/4 per cent, although he would not press hard for that. Like Mr. Bucher, however, he did not want interest rates to move back up, and therefore, he would set a ceiling of 9 per cent on the funds rate.

Mr. Winn remarked that he was disturbed by the high and unanticipated rate of expansion in the aggregates in the latest few weeks. It might be useful to devote more resources to obtaining better projections, if possible, in order to improve the performance of policy. Looking ahead, he was concerned about inflation and about the potential international flows of funds, and he hoped that the high rate of monetary expansion would not continue into March. Desiring a steady policy, one that would not indicate a further decline in short-term interest rates, he favored alternative B, leaning toward alternative C.

Mr. Clay commented that he wished to applaud the portion of the statement for the House Appropriations Committee that the Chairman had read to the Committee earlier. The statement recognized inflation as the nation's primary problem and yet did not ignore the problem of unemployment. It contained suggestions to alleviate that problem--suggestions that were beyond the power of the Committee to implement, but which the nation should address.

Continuing, Mr. Clay said monetary policy should provide enough money and credit to accommodate economic recovery in the second half of the year. But the Committee's concerns in that direction must not be allowed to overshadow a fundamental commitment to reduce the excessive rate of inflation built up over the past few years. Growth in the aggregates indexed by M_1 growth for the first and second quarters combined of 5 per cent seemed now, as it did a month ago, the proper policy to insure that the coming recovery took place in an environment conducive to meeting a long-run goal of steady noninflationary growth. That target could probably be achieved with a Federal funds rate at or somewhat above the current level. Treasury bill rates could be expected to rise a little when investors realized that they had over-discounted Federal Reserve easing intentions. That should not concern the Committee so long as signs of additional weakness in aggregate demand did not become apparent. In view of those considerations, he favored alternative C. However, he could accept alternative B.

Chairman Burns observed that views of the Committee members varied widely, although not as widely as one might expect in such a difficult period. He had already indicated the tenor of his own thinking in a general way, and would add just a few comments. The country at present was on the threshold of a two-digit inflation. If headway were not made this year in dealing with the problem, the country would be experiencing a Latin American type of inflation, and the American people would not tolerate that for long. One way or another, highly restrictive policies would become inevitable and the nation might have to go through a long and serious economic contraction. By leaning on the side of caution now, the Committee might be able to make some contribution to preventing such an unfortunate development. Although he was inclined to think the Committee would--and should--move further in an easing direction, the question of timing was critical. Interest rates had declined sharply over the past month, and in view of market expectations, it would be wise to mark time for a while. If the economic news over the next 2 or 3 weeks continued to be unfavorable, the Committee might well decide that further easing moves were appropriate.

The Chairman suggested that the Committee proceed to reach its decision step by step, starting with the language of the operational paragraph of the directive. An informal poll might be taken to determine whether the members preferred alternative B or one of the alternatives that Mr. Daane had suggested.

A majority of the members indicated that they favored the language of alternative B.

The Chairman observed that the Committee had not had a systematic discussion of the longer-run targets. He assumed it would be acceptable to the members to continue the longer-run target of 5-3/4 per cent for M_1 that had been adopted at the January meeting, along with the associated targets for M_2 and the credit proxy specified under alternative B in the blue book.

There were no objections to those longer-run targets.

Chairman Burns next suggested that the Committee consider the short-run ranges of tolerance. For the weekly average Federal funds rate, he proposed a range of 8-1/2 to 9-1/2 per cent, which was somewhat narrower than in the recent past. For the sake of consistency, he suggested that the short-run ranges of tolerance for growth rates in the aggregates over the February-March period be somewhat wider than usual, and he proposed to widen them by reducing the lower limits of the ranges specified under alternative B by 1 percentage point. Thus, he suggested ranges of 3-1/2 to 6-1/2 per cent for RPD's, 6-1/2 to 9-1/2 per cent for M_1, and 9-1/2 to 12-1/2 per cent for M_2.

An informal poll indicated that one-half of the members of the Committee found those short-run ranges of tolerance more or less acceptable.

Mr. Mitchell remarked that he would prefer to set the lower limit for the funds rate at 8-1/4 per cent rather than 8-1/2 per cent.

Chairman Burns suggested that the members express their preference between ranges of 8-1/4 to 9-1/2 per cent and 8-1/2 to 9-1/2 per cent for the funds rate. A majority of the members indicated that they would prefer a range of 8-1/4 to 9-1/2 per cent. A subsequent poll also indicated that the altered funds range along with the other short-run ranges of tolerance suggested by the Chairman were more or less acceptable to a majority of the members.

Mr. Sheehan observed that while he had expressed a preference for the lower of the two funds rate ranges the Chairman had mentioned, he really preferred a still lower range. While he might be wrong, he believed that the specifications proposed by the Chairman would lead to a tightening of policy and a rise in interest rates over the next 3 or 4 weeks.

In response, Chairman Burns said the import of the specifications he had suggested was that the Federal funds rate would remain more or less where it was; the 3 percentage point short-run ranges of tolerance for the aggregates would provide for a fairly wide zone of indifference with respect to their growth rates.

Repyling to a question by Mr. Hayes, Chairman Burns observed that he contemplated that in the immediate future the Manager would hold the funds rate about where it was--that is, within a range of 8-3/4 to 9-1/4 per cent. And he reminded the members that in the event of unexpected developments, the Committee could consult promptly and, as had been done many times in the past, alter the specifications.

Mr. Mayo said he agreed with the widening of the short-run ranges for the aggregates to 3 percentage points, but the ranges were centered too low. The 6-1/2 per cent lower limit proposed for M_1, for example, was below the lower limit specified under alternative C in the blue book. A range of 7 to 10 per cent would be more appropriate.

Mr. Holland observed that, on the contrary, the ranges proposed for the aggregates were on the high side, because of the strength shown by the data for the latest 2 weeks. For the latest week, the data were still preliminary and might very well be revised downward.

Mr. Bucher remarked that he was troubled by the prospect that stability in the Federal funds rate, together with the short-run ranges proposed for the aggregates, was much more likely to lead to some backing up of short-term market rates than to any further decline.

In response to a question by Mr. Sheehan, Mr. Holmes commented that a steady funds rate might be accompanied by some backing up in other short-term rates; such a development would not be unusual.

Chairman Burns observed that the general decline in short-term interest rates in recent weeks had been excessive in relation to the movement in the funds rate, and some correction was likely. It would be better to allow the correction to occur now rather than to encourage further sharp declines in rates leading to a larger correction later on.

Mr. Bucher remarked that a correction might not occur if the System took additional actions to ease policy.

The Chairman commented that the real question seemed to him to be whether the easing in policy was to be gradual or abrupt.

Mr. Mitchell remarked that he thought some members of the Committee were disturbed by the proposed short-run ranges of tolerance for the aggregates because--with M_1 growth in February already indicated to be high--they implied a need to achieve a much lower rate of growth in March.

In response to a question by Chairman Burns, Mr. Bucher said he would like to have another poll taken with respect to a possible reduction of the lower limits for the short-run ranges for the aggregates.

The Chairman called for an expression of preference between the short-run ranges specified under alternative B in the blue book and the widened ranges he had proposed. A majority of the members indicated that they preferred the widened ranges.

Chairman Burns then proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs and the language of alternative B for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The longer-run targets--namely, annual rates of growth for the first and second quarters combined--would be 5-3/4, 10, and 8-3/4 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the February-March period would be 3-1/2 to 6-1/2 per cent for RPD's, 6-1/2 to 9-1/2 per cent for M_1, and 9-1/2 to 12-1/2 per cent for M_2. The range for the weekly average Federal funds rate in the intermeeting period would be 8-1/4 to 9-1/2 per cent.

> With Messrs. Bucher, Francis, Morris, and Sheehan dissenting, 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 domestic policy directive:

> The information reviewed at this meeting suggests that real output of goods and services is declining in the current quarter, mainly because of the oil situation, and that prices are continuing to rise rapidly. In January industrial production declined

again, nonfarm payroll employment dropped, and the unemployment rate rose above 5 per cent. Prices of both farm products and industrial commodities increased very sharply. Wage rates have continued to rise substantially in recent months, although not so sharply as prices.

After having appreciated for several months, the dollar has declined somewhat on the average against foreign currencies in recent weeks. U.S. controls on capital outflows were removed at the end of January, and several foreign countries have relaxed controls on capital inflows. The U.S. trade surplus rose sharply in December and in the fourth quarter as a whole.

The narrowly defined money stock, after increasing substantially in the last 2 months of 1973, declined in January; most recently, however, it has appeared to strengthen. Broader measures of the money stock continued to rise in January, as net inflows of consumer-type time deposits remained relatively strong. Expansion in business loans and in total bank credit accelerated, and banks stepped up issuance of large-denomination CD's. Since mid-January, short-term market interest rates have fallen appreciably, and long-term rates have declined somewhat.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, cushioning declines in production and employment that are being induced in large part by the oil situation, and maintaining equilibrium in the country's balance of payments.

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Secretary's note: The specifications agreed upon by the Committee, in the form distributed following the meeting, are appended to this memorandum as Attachment C.

The Chairman then noted that the Committee had planned to discuss two further matters today. One was the staff's recommendations regarding the release of the 1968 FOMC minutes with certain sensitive passages withheld, which had been briefly considered at the previous meeting. The other was the report of the staff committee on bankers' acceptances, dated January 29, 1974, and entitled "Recommendations on Desk Operations in Bankers' Acceptances."1/

Mr. Mitchell said he would be prepared to approve the staff recommendations regarding the 1968 minutes but would prefer to have the report on bankers' acceptances held over until the next meeting.

Mr. Brimmer expressed a similar view.

> By unanimous vote, transfer to the National Archives of the FOMC minutes of actions and memoranda of discussion, on the basis described in a memorandum from the Secretariat dated January 14, 1974, was authorized.

Mr. Brimmer suggested that the staff be asked to review again the desirability of reducing the lag in the release of FOMC policy records from the present 90 days to 60 days. The next meeting of the Committee would be the annual organization meeting, and

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

that would be an appropriate time for the Committee to consider the matter once more.[1/]

It was agreed that the next meeting of the Committee would be held on March 19, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida
Secretary

1/ Subsequent to the meeting, in response to an inquiry by the Chairman, the Secretary expressed the view that this would not be a good time for the Committee to deliberate on the desirability of such an innovation in policy record procedures, primarily because another innovation--the inclusion of quantitative information on the Committee's short-run targets--was about to be made.

ATTACHMENT A

Ralph C. Bryant
February 20, 1974

FOMC Briefing on International Developments

(Mr. Bryant supplied the following detailed statement for the record. His oral remarks at the meeting summarized the main points of this statement.)

There are several reasons to be apprehensive about the world balance-of-payments situation and the outlook for the world economy.

Another month's work has not led analysts of world payments to scale downwards the estimates of the impacts of last year's increases in petroleum prices. Thus, so long as these prices persist at anything like their present levels and petroleum production is not cut back sharply, the OPEC countries as a group are expected to run a staggering current account surplus in 1974 -- probably some $50 billion or more. A correspondingly large current account deficit will have to be accepted by the industrial and non-oil developing countries.

The huge current account surplus of the OPEC countries will necessarily lead to an accumulation by them of foreign assets. So far, however, there is hardly any concrete evidence either about the forms that this capital backflow will take or its country distribution. Whatever the forms and country distribution, we do know that serious financing problems lie ahead. There is no reason, for example, to believe that the country distribution of the capital backflows will match up smoothly with the country pattern of current account deficits.

Parenthetically, I might note that most thinking about this oil-generated transformation of the world payments situation has focused on the problem of how to get through the year 1974. The outlook for 1975 and beyond depends critically on the evolution of petroleum prices. However, short of a rollback in oil prices that reverses the bulk of the 1973 increases -- and that much of a rollback seems to me quite unlikely -- the chances are good that 1975 will see us still struggling with the unprecedented financing problems that loom before us for 1974.

Within the overall picture, the outlooks for individual countries' balances of payments vary greatly. A number of industrial countries, for example, have prospects that appear tolerable for the remainder of 1974; this group includes Germany, the Benelux countries, Switzerland, Norway, and Sweden. Japan and France appear to be cases of intermediate difficulty, in the sense that national authorities there believe they can see their way clear, without encountering serious obstacles, to arranging adequate financing. The United States is a special case, since it is the country whose capital account is thought most likely to be strengthened, albeit indirectly, by the backflow of funds from OPEC countries.

The real pressure points in the payments outlook for major industrial countries are the United Kingdom and Italy. Taken together, these two countries have been projected as running current account deficits in 1974 of some $12-15 billion. Both already borrowed heavily in 1973 to finance what were already weak current-account positions. To give you only the concluding judgment and none of the analysis: the U.K. and Italy both are likely to run into financing difficulties this year; both have very difficult domestic economic situations; and both may experience severe pressures on their exchange rates in coming months.

The external payments and reserve positions of individual non-oil developing countries also vary. Some of these countries, having already benefited from last year's surge in commodity prices, are no more poorly placed than industrial countries to cope with their larger bills for oil imports. Many other developing countries, however -- India is a prime example -- are moving into positions that genuinely seem to deserve the adjective "desperate."

This already troublesome situation has still another complicating dimension. If one adds up (as Working Party 3 of the OECD did last week) all the national aims or forecasts for industrial countries' current account balances, and adds in a provisional estimate for the deficits of the non-oil LDCs, one finds that there are not enough projected deficits to match the surpluses that OPEC countries are expected to have. National aims or forecasts are incompatible in the aggregate, and one or more individual countries are bound to have their aims or forecasts frustrated. An incompatibility has often existed in the past, but this year -- with the ball game having been drastically altered by the oil price increases -- the incompatibility is of a more serious magnitude; and there is also a much greater risk of national policy actions that, seen from the perspective of the world situation as a whole, can turn out to be competitive and self-defeating.

If the world payments situation provides grounds for being apprehensive, so does the world-wide outlook for inflation and economic activity. Again, of course, the prospects for individual countries vary widely. By and large, however, the outlook is for an onerous combination of extraordinarily high rates of price increase and substantial weakening in real output.

Every major industrial country is expected to register a worse price performance this year than last. As you well recall, last year already notched up inflation rates to distressing heights; increases in consumer prices in major industrial countries during 1973, for example, ranged from a low of some 7 percent upwards to 15-20 percent. (The figure for the United States itself was nearly 9 percent.)

Despite this worsened outlook for inflation, the risks of slipping into a generalized recession in real activity and employment later this year seem uncomfortably great. Some data -- notably for industrial production and for employment -- already bear witness to a slackening of real growth in Europe and Japan. While this evidence does not yet clearly presage an excessive slowdown, those who judge the risks of a generalized downturn to be greatest emphasize that the contractionary effects on real demand of the higher oil prices are for the most part still in the pipeline; not enough time has elapsed, they argue, for the bulk of these effects to have begun to show in actual statistics. The peak contractionary effect in Europe and Japan would, on this view, occur during the second half of 1974. This bearish picture differs, of course, from the relatively optimistic official forecasts of most national authorities, who see a pick-up in real activity in the second half of the year after a temporarily weak first half.

In concluding, I want to emphasize the interdependence between the outlook for economic activity and the outlook for balances of payments. If a generalized downturn in real activity were actually to materialize, the balance-of-payments pressures on the United Kingdom, on Italy, and on many of the LDCs would be further intensified. These countries can try to pursue policies that make room for the supply of additional exports, and thus hope to bring about smaller deficits in their weak current accounts. But whether their exports actually expand at a more rapid rate is obviously not entirely up to them; it depends in a critical way on the evolution of demand in the economies of their trading partners.

At a minimum, the countries with weak balances of payments will not be in a position to take the lead in stimulating domestic demand should such a stimulus be needed in the industrial economies. Hence the authorities of those countries with stronger balance-of-payments positions -- especially the United States and Germany -- have not only a great responsibility to their own citizens, but also an important responsibility to the rest of the world, for recognizing promptly, and dealing with expeditiously, any excessive softening in production and employment that begins to develop in their own economies.

ATTACHMENT B

February 19, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on February 29, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services is declining in the current quarter, mainly because of the oil situation, and that prices are continuing to rise rapidly. In January industrial production declined again, nonfarm payroll employment dropped, and the unemployment rate rose above 5 per cent. Prices of both farm products and industrial commodities increased very sharply. Wage rates have continued to rise substantially in recent months, although not so sharply as prices.

After having appreciated for several months, the dollar has declined somewhat on the average against foreign currencies in recent weeks. U.S. controls on capital outflows were removed at the end of January, and several foreign countries have relaxed controls on capital inflows. The U.S. trade surplus rose sharply in December and in the fourth quarter as a whole.

The narrowly defined money stock, after increasing substantially in the last 2 months of 1973, declined in January; most recently, however, it has appeared to strengthen. Broader measures of the money stock continued to rise in January, as net inflows of consumer-type time deposits remained relatively strong. Expansion in business loans and in total bank credit accelerated, and banks stepped up issuance of large-denomination CD's. Since mid-January, short-term market interest rates have fallen appreciably, and long-term rates have declined somewhat.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to resisting inflationary pressures, cushioning declines in production and employment that are being induced in large part by the oil situation, and maintaining equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with somewhat greater growth in monetary aggregates over the months ahead.

Alternative B

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with moderate growth in monetary aggregates over the months ahead.

Alternative C

To implement this policy, while taking account of international and domestic financial market developments, the Committee seeks to achieve bank reserve and money market conditions consistent with quite moderate growth in monetary aggregates over the months ahead.

ATTACHMENT C

February 20, 1974

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 2/20/74)
A. Longer-run targets (SAAR): (first and second quarters combined)	M_1	5-3/4%
	M_2	10%
	Proxy	8-3/4%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (February-March average):		3-1/2 to 6-1/2%
2. Ranges of tolerance for monetary aggregates (February-March average):	M_1	6-1/2 to 9-1/2%
	M_2	9-1/2 to 12-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		8-1/4 to 9-1/2%
4. Federal funds rate to be moved in an orderly way within range of toleration.		
5. Other considerations: account to be taken of international and domestic financial market developments.		

C. 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.