MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C. on Tuesday, September 10, 1974, at 3:15 p.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Black
Mr. Bucher
Mr. Clay
Mr. Holland
Mr. Kimbrel
Mr. Mitchell
Mr. Sheehan
Mr. Wallich
Mr. Winn

Messrs. Coldwell, MacLaury, Mayo, and Morris, Alternate Members of the Federal Open Market Committee

Messrs. Eastburn, Francis, and Balles, Presidents of the Federal Reserve Banks of San Francisco, Philadelphia, and St. Louis, respectively

Mr. Broida, Secretary
Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. O'Connell, General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Bryant, Gramley, Parthemos, Pierce, and Reynolds, Associate Economists

Mr. Sternlight, Deputy Manager, System Open Market Account

Mr. Wonnacott, Associate Director, Division of International Finance, Board of Governors
Mr. O'Brien, Special Assistant to the Board of Governors
Messrs. Keir and Williams, Advisers, Division of Research and Statistics, 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. Eisenmenger, Boehne, and Scheld, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, and Chicago, respectively
Mr. Meek, Monetary Adviser, Federal Reserve Bank of New York
Mr. Fousek, Economic Adviser, Federal Reserve Bank of New York
Mr. Cox, Assistant Vice President, Federal Reserve Bank of Atlanta
Mr. Rolnick, Economist, Federal Reserve Bank of Minneapolis

Chairman Burns said he regretted any inconvenience that might have been caused the members by the rescheduling of this meeting of the Committee from 9:30 a.m. tomorrow to this afternoon. The rescheduling had been necessary because of conflict with one of the "pre-summit" meetings called by the Administration. As the Committee members were aware, the President had met with a group

of professional economists in the first pre-summit last week. The second such meeting, with labor leaders, would be held tomorrow, and the President had asked him to be present.

The Chairman said it was extremely important that the Committee take whatever time was needed at this meeting for a thorough discussion of the state of the economy and the appropriate course of monetary policy. Today's session might continue until 7:00 or 7:30 p.m., and if more time was required, the meeting could be reconvened for an hour or so early tomorrow morning and again tomorrow afternoon.

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

Mr. Gramley made the following statement:

> Business sentiment seems to have become noticeably more pessimistic in recent weeks. There have been increasing reports in the red book[1] and elsewhere of cancellations of business capital spending plans, of greater caution in inventory policies because of excess stocks and high interest rates, and of weakening in consumer demands for household furnishings and appliances.
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> The August report of the National Association of Purchasing Management was particularly bearish. Noting

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

further declines in the diffusion indexes for both new orders and production, the NAPM interpreted these as "flashing warning signals that the current recession is beginning to permeate a broader segment of the economy."

Some of the statistics becoming available since the last Committee meeting, however, have had a bit more positive tone, and the staff has not altered significantly its view of the economic outlook. Prospects look to us gloomy, but they did a month ago too.

We do not have a good reading yet on industrial production in August, but it appears that output was at about the same level as, or slightly below, the July figure. Such physical volume data as we have show little change in output between the 2 months, but total manhours worked in manufacturing were off 0.7 per cent in August.

Auto assemblies, which remained at around an 8 million annual rate in August, are scheduled to rise to just under a 9 million rate in the fourth quarter if sales hold up. Our staff believes, however, that these tentative production schedules are likely to be revised down. Currently high sales rates probably reflect efforts of consumers to beat price increases on 1975 models and will not be sustained.

Employment data for August also suggest a continued sideways movement in the economy. As you know, the unemployment rate edged up to 5.4 per cent, and initial claims for insured unemployment have risen further since the mid-August survey week. There was a moderate rise last month in total nonfarm employment--that is, the payroll series--but it was centered in services and State and local government. Manufacturing employment was down, owing partly to strikes, and construction employment recovered by much less than the number of striking workers returning to their jobs. Since May, employment in construction has declined by about 120,000--or around 3 per cent.

The most puzzling statistics to come in during recent weeks have been those relating to business fixed capital investment. Manufacturers' capital appropriations rose dramatically in the second quarter--

especially in the materials industries--and new orders for nondefense capital goods climbed another 6 per cent in July. There is, I believe, substantial reason to expect further increases in real investment in those industries where we need it most from the standpoint of eliminating shortages and relieving inflationary pressures.

Outside the materials industries, however, a marked deterioration seems to be occurring in business investment intentions. Publicly announced cancellations of capital spending plans that we have been keeping track of since April have risen another $1-1/2 billion since the last FOMC meeting, and now total over $10 billion, including at least $900 million in cutbacks during 1974.

The cancellations are mainly in utilities, but there is reason to believe that other, less publicized cutbacks are occurring elsewhere. Thus, the latest Commerce Department survey of anticipated plant and equipment expenditures shows a progressive deterioration in expected outlays for the latter half of this year that affects manufacturing as well as nonmanufacturing activities. The weight of the evidence points, we believe, to a modest decline in aggregate real business fixed investment in coming quarters.

In weighing all the incoming facts, our staff has found no good reason to revise in any major way its GNP projection for the rest of this year and on through 1975. We have incorporated into this projection a cutback in Federal spending to just under $300 billion, on a unified budget basis, but we have allowed for some additional Federal assistance to housing in the first half of next year. These are minor changes, and the real GNP pattern that emerges is rather like what it was 3 weeks ago--with declines through the first half of 1975 and a moderate pickup thereafter. As before, the unemployment rate reaches a level around 7-1/4 per cent late next year.

Our price projections are a little more gloomy than they were last time, though not greatly so. The size of recent wage and price increases has surprised us once again, but we see some relief towards the end of the forecast period because a reasonable case can be made for an abatement of special factors, and the

> beginnings of a cooling off of underlying inflationary pressures, in the economic environment projected. As you are well aware, however, our staff forecasting record in the price area has not been good, and these current price projections are subject to a very wide margin of error.
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> I feel somewhat more confident that our projection of real activity is in the right ball park--assuming no change in monetary policy and a moderately more restrictive course of fiscal policy. But if we have erred, I believe the error lies in the direction of underestimating the severity of the downward adjustment that seems to lie ahead.

Mr. Morris referred to Mr. Gramley's comment that any error in the staff's projection was likely to be in the direction of overestimating the strength of economic activity, and asked whether the uncertainties were mainly in the area of inventory investment. He noted in that connection that the staff at the Boston Reserve Bank found it difficult to reconcile the inventory estimates with the rest of the projection. In their view, final demands as weak as projected would be associated with a more severe inventory contraction than the Board staff anticipated.

Mr. Gramley agreed that inventory investment represented one element of uncertainty in the Board staff's judgmental projection. That projection called for a higher level of inventory investment than suggested by the Board's econometric model, in part because it seemed possible that the upward adjustment for bias incorporated in the Commerce Department's inventory estimates

from the end of 1972 forward might have resulted in an overstatement of the current level of inventories. Also, it seemed unlikely that the inventory pattern typical of most recessions would be repeated in this cycle; while weakness was expected in many sectors, it was anticipated that business fixed investment would remain high relative to other recessionary periods and that the demand for materials would continue strong. But, as Mr. Morris had suggested, any errors in the projections of inventory investment were likely to be in the direction of overestimation relative to final sales.

Mr. Mayo observed that he was somewhat more optimistic than the Board staff. For one thing, the capital sector still seemed very strong. Moreover, the pattern of the projection over time seemed unrealistic; to his knowledge, there had never been a series of quarters in which real GNP remained essentially unchanged as long as that indicated.

Mr. Gramley agreed that the staff projection could be questioned on the basis of historical precedents but indicated that he nevertheless considered it to be a reasonable possibility. As to the outlook for fixed capital investment, there was ample room for differences of view, particularly in light of the puzzling nature of some of the evidence. For example, the latest Commerce Department survey of business plans indicated an annual rate of increase in aggregate spending on plant and equipment of 8.4 per cent from

the second to the fourth quarter of 1974. Taken literally, that increase in nominal spending would imply a sharp decline in real expenditures on plant and equipment. It was difficult to interpret such a statistic.

Mr. Hayes said that, like Mr. Mayo, he was somewhat more optimistic than the Board staff about the general economic outlook. Whereas the Board projection called for a small decline in real GNP for several quarters, projections made by the staff at the New York Reserve Bank suggested a small, positive growth rate in real GNP over the same period. For one thing, the Bank projection of consumer spending over the next five quarters was stronger than that of the Board--apparently as a result of the Bank forecast of a decline in the rate of personal saving. He would like to have more detail about the assumptions underlying the Board projection of rather sluggish consumer expenditures.

In response, Mr. Gramley said the projected sluggish performance of consumer spending reflected the expected sluggish performance of real income. He saw nothing in the information available on consumer attitudes to indicate that consumers would increase expenditures relative to income. The econometric model implied the opposite; given the trends likely for expenditures in the nonconsumer sectors, the model suggested that the personal

saving rate was more likely to rise than to fall. The absence of a rise in the saving rate in the judgmental model was probably the chief cause of difference between the judgmental and econometric projections.

Mr. Hayes then asked about the specific assumptions underlying the staff projection that Federal spending would be less than $300 billion in the 1975 fiscal year.

Mr. Gramley replied that the major assumptions were: deferment of pay raises for Federal workers from October 1 until January 1; a 40,000 cutback in Federal employment; postponement of the expansion in the public service employment program until the last quarter of the fiscal year; and a $2 billion reduction in defense outlays, which was consistent with the legislation approved by the Senate. Of course, it was not certain that those economies would actually be realized.

Mr. Hayes observed that, in view of the weakness in economic activity anticipated by the Board staff, and given the assumption that M_1 would grow at a rate of 5-3/4 per cent, he would have expected the staff to project some decline in short-term interest rates over the next four quarters. However, the projection appeared to imply little net change in short-term rates.

In response, Mr. Gramley noted that, as a result of the anticipated pace of price advance, nominal GNP was expected to grow over the projection period at an average rate of about 7-1/2 per cent--well above the 5-3/4 per cent growth rate assumed for M_1. In his judgment, that relationship would be consistent with a sort of rough stability in short-term interest rates over the period as a whole. In the near term, however, rates would not necessarily be stable.

Mr. MacLaury remarked that, like Mr. Morris, he was skeptical about the staff projection of the inventory-sales ratio; he was inclined to doubt that that ratio would remain at historically high levels through 1975. Another point that concerned him was the effect of recent stock market behavior on spending. First, it seemed to him that the low level of prices of common stocks cast doubt on the likelihood of an upturn in the growth rate of consumer spending in the second half of 1975. Secondly, the decline in stock prices would have an effect on the cost of capital and, consequently, on business fixed investment. He wondered whether it would not be necessary to have a substantial upturn in stock prices to achieve the levels of consumer spending and business fixed investment projected by the Board's staff.

Mr. Gramley said he did not believe so, although he might note that to an important extent the projection of consumption expenditures yielded by the econometric model was lower than that in the judgmental estimates because of the strength of the wealth effect in the model's consumption equation. The upturn in consumer spending projected by the staff for the latter half of 1975 was based on the increase in disposable income expected to result from increased social security payments and an anticipated redistribution of income toward wage earners, reflecting the combination of an expected slowing of inflation and continued large increases in nominal wage rates. There was no assumption of a significant decline in the rate of saving.

Continuing, Mr. Gramley remarked that the econometric model's projection of business fixed investment, which did take into account changes in the cost of capital, was no more pessimistic than the judgmental forecast. There were, however, differences in composition; the econometric model suggested more spending on durable equipment and less on structures.

Mr. Eastburn observed that the projection made by the staff at the Philadelphia Reserve Bank also was slightly less pessimistic than that of the Board staff, particularly in the area of residential housing. He wondered if Mr. Gramley would comment on that

sector and also summarize the main differences between the econometric and judgmental projections.

In response, Mr. Gramley said the two projections were basically similar with respect to the over-all pattern of future changes in real GNP; the primary difference lay in the structure of expenditures. For example, the econometric model yielded substantially higher figures for net exports and residential construction but considerably lower figures for personal consumption expenditures and inventories than did the judgmental model.

With respect to residential construction in particular, Mr. Gramley continued, the econometric model implied that the effects of credit availability on the housing market were of relatively short duration and that, over the long run, the real interest rate was a more important determinant of residential construction. It was the opinion of the staff, however, that an upturn in housing was not likely unless there were a significant improvement in the mortgage market.

Mr. Balles said it was his impression, based partly on a review of the economic situation with the directors of the San Francisco Reserve Bank, that there were strong cross-currents in the economy, particularly in the area of inventories. On the one hand, there was concern about possible involuntary inventory

accumulation in housing-related consumer goods. On the other hand, in such industries as steel, petrochemicals, and paper products, firms were having difficulty in maintaining inventories at a reasonable level relative to sales. In light of such differences, he would be inclined to exercise caution in making broad assumptions about inventory trends.

Mr. Balles said he would like to associate himself with those members who were more optimistic about the outlook for capital spending and the economy than the Board staff. On the whole, while he thought the staff's projection of a decline in real GNP through mid-1975 was within the range of reasonable possibilities, he suspected that it erred on the pessimistic side.

Chairman Burns remarked that it might be helpful if he were to follow up Mr. Balles' comment on inventories by reading some excerpts from a report on a survey conducted by the Commerce Department in August. The survey, which covered a number of major U.S. corporations, focused on the question of existing shortages of materials.

First, he might cite the following statement from the general summary:

> The items reported to be in shortest supply appeared to be steel and related products such as scrap and castings, paper and paperboard, polyvinyl chloride, soda ash, caustic soda, chlorine, aluminum, zinc, and various types of equipment.

One of the respondents explained the reasons why the situation for a series of products had worsened in the past few months as follows:

> Anthracite coal--mine regulations, rail car shortage; calcined anthracite coal--reduced capacity due to pollution regulations; magnesium--inadequate production capacity vs. demand, coupled with end of stockpile availability; silicon--inadequate production capacity and pollution abatement requirements causing temporary shutdowns; steel--mills are late on deliveries and warehouse stocks short, booking orders without prior buying history is impossible; machinery and equipment--due in part to shortages of steel, castings, bearings, and other components.

One large corporation indicated that it had established a task force

> to exert an all-out effort to identify substitutes for polyvinyl chloride used in the various. . .components. Many of the alternative materials, however, are already in short supply.

Another corporation reported the following:

> Of particular concern at this time is the delivery delay--if not outright unavailability--of many metal products made of steel, copper or aluminum. It has become apparent that these producers are shortening their product lines in order to increase productivity. This situation has resulted in a 100 per cent increase of our material shortages follow-up and sourcing work. Almost every purchase order for major equipment now requires expediting. The majority of the purchase orders placed now take longer to be completed, entail additional negotiation and, in too many cases, require follow-up prior to receipt.

The Chairman said he would conclude from those comments, first, that it was very difficult to generalize about the economy

at this time; aggregate data could be highly misleading when so many particular markets were in disequilibrium. Secondly, existing shortages were limiting the economy's capacity to produce. At the same time, such shortages also served to maintain employment because employers do not lay off workers when materials are unavailable; they maintain the work force in the expectation that delivery of materials will occur eventually, thus in effect hoarding labor.

Chairman Burns then asked Mr. Gramley for his views on the implications of the survey findings.

Mr. Gramley said it seemed to him that the report failed to take into account recent indications that shortages had become less acute. In the last 3 or 4 months, in particular, the supply situation had improved substantially for many commodities--for example, petrochemicals and steel. There were reports that all types of steel were available now if the purchaser was willing to pay the price. To the extent that the survey findings were valid, however, the principal implication, in his opinion, was that the downturn would be less serious than it might otherwise be; the expansion of capacity in those areas where shortages continued, such as industrial materials, would help sustain economic activity. That consideration was one of the factors underlying the staff projection.

The Chairman, noting that that conclusion applied mainly to the short run, remarked that he would draw another implication as well: if deficiencies in demand cumulated, there was likely to be a sharp decline in employment in the longer run. As he had mentioned earlier, businesses had maintained employment in cases where production had declined because of shortages. If demand weakened cumulatively and the shortages ended, the decline in employment would be larger than that in production.

Mr. Coldwell noted that the recent pattern of labor force growth had been rather volatile; the increase last year had been quite large, but this year there had actually been declines in some months. He asked if the staff thought that the historical pattern of labor force participation was likely to be resumed or whether it was possible that there would be sufficient flexibility in participation rates to permit a decline in employment without a rise in unemployment.

Mr. Gramley said the latter was not impossible. In its projections the staff had assumed a reasonably normal pattern of labor force expansion for this stage of a cycle. Specifically, it had projected a slowdown in labor force growth to about 900,000 from the fourth quarter of 1974 through the fourth quarter of 1975, or about one-half the rate of 1.6 or 1.7 million that would be

consistent with population trends and participation rates in the absence of a cyclical contraction. It was possible, of course, that labor force growth would be even less than projected.

Chairman Burns observed that the slowdown assumed was a considerable one. There was no great regularity in the behavior of the labor force during business cycles. Historically, the rate of growth in the labor force had diminished in roughly two-thirds of the contractions, but in some contractions it had actually increased. In his opinion the staff had made a rather conservative assumption.

Mr. Francis commented that, along with some other speakers, he anticipated a little more strength in the economy than was indicated by the Board staff's analysis. He had the impression from recent discussions with representatives of major corporations in the Eighth District that shortages of some raw materials, such as steel, were easing slightly, and that might have implications for inventory investment. However, none of the businessmen with whom he had talked indicated that their companies had reduced their capital spending programs for 1974. Indeed, one company had increased its capital budget by one-third. However, the added spending reflected higher prices rather than additional real capacity.

Mr. Francis then said he had been rather puzzled by the continued net growth in nonfarm employment so far this year in the face of

declining real output. While Chairman Burns had touched on that subject, he wondered if the staff had any further comments.

Mr. Gramley remarked that there were two possible explanations of the recent relationship between employment and real output. As Chairman Burns had suggested, there might well be some labor hoarding, particularly in industries which had experienced shortages of materials. Secondly, it was possible that the GNP statistics overstated the weakness in the economy during the first half of the year. There was some support for that possibility in the fact that employment data for the trade and service industries were stronger than seemed consistent with the GNP figures. It was possible, of course, that both explanations were valid.

Mr. Wallich said he would have expected average weekly hours to fall sharply if employers were hoarding labor. However, there had not been such a decline in hours.

The Chairman noted that the weekly hours data reflected hours paid for rather than hours worked. While an employer could eliminate overtime work when shortages made it necessary to reduce production, he might well find it difficult to cut back on the regular work week, particularly in industries where skilled workers were hard to find.

Mr. Wallich then noted that the staff projections suggested that the rise of U.S. exports, while slowing somewhat, would remain substantial. The volume of exports would, of course, depend on the level of farm prices and exchange rates for the dollar, among other things. Given the state of economic conditions abroad, however, he was skeptical about the magnitude of the rise projected.

Mr. Bryant commented that the most uncertain part of the export projections was that for agricultural exports, because agricultural prices were changing so rapidly. As for nonagricultural exports, the projections might well be too optimistic; if he were revising them today, he probably would lower them somewhat.

Mr. Winn said he also would like to associate himself with those who were more optimistic than the Board's staff about the economic outlook. His attitude was based in part on recent developments in the construction industry, which had been experiencing particularly severe problems. Even though the situation of builders in his District had worsened in some respects during recent months, their attitudes had improved considerably; they now seemed to be facing up to their problems rather than giving in to feelings of despair. Furthermore, the demand for apartments seemed to be picking up, and it appeared likely that rents could be increased enough to make apartment building profitable--even with the present

cost of money, increases in utility rates, and potential increases in taxes. He thought it was possible that the economy was now in a transition phase, and that some of the current difficulties might be resolved more quickly than the staff's projections implied. However, a lengthy coal strike this fall could cause serious problems. Coal inventories of public utilities and steel companies were extremely low at present.

The Chairman said he had heard reports that the current strong demand for steel reflected expectations of a coal strike, and that steel mills might have to shut down after 3 weeks if there was a strike.

Mr. Black said some observers thought that, in view of the strong demand for coal, the coal company operators might yield to the union demands rather quickly. However, that view was not unanimous.

The Chairman asked whether the staff had any comments on the likelihood of a revival in apartment construction.

Mr. Gramley said it was very likely that there would be a buildup in the backlog of demand for housing--particularly for apartments, because single-family housing had become too expensive for the average consumer. He believed, however, that an upturn in apartment construction would be dependent on two developments.

First, there would have to be a substantial increase in rents; the trend toward condominiums undoubtedly reflected the unprofitability of new rental units at the current level of rents. Secondly, there would have to be a significant easing in the availability of funds for multi-family dwellings. The difficulties experienced by real estate investment trusts had substantially reduced the availability of such funds, and as yet no alternative sources had been found.

Mr. Mitchell observed that at a meeting the Board had held with representatives of the Mortgage Bankers Association of America last week, one mortgage banker had made a rather striking comment. He had said that all poor builders had failed in 1973; that average builders were in trouble now; and that, if conditions did not improve, the good builders would be in serious trouble by the end of the year. Comments by others in the group also were disheartening. He might also mention the reports in recent red books warning of potential builder failures if materials shortages, reduced availability of funds, and the high cost of funds continued. It seemed to him that some of the builders who were optimistic about their prospects were simply myopic.

The Chairman remarked that conditions in the construction industry probably differed substantially by region. For the country

as a whole, the available data suggested that there had been over-building of both apartments and office buildings. For apartment buildings, vacancy rates were now higher than they had been for several years.

Mr. Gramley said that, although vacancy rates had risen, the amount of overbuilding of multi-family structures did not appear to be nearly as great as it had been in, say, 1965.

Mr. Winn said it was his impression that the problem of overbuilding was concentrated mainly in office buildings, although even in that field conditions differed by region.

Mr. Mitchell observed that there were other trouble spots, including condominiums, second homes, and motels. The problem of over-commitment was most dramatically displayed in the difficulties being experienced by REIT's.

Mr. Black asked whether business efforts to deal with inventory problems were likely to have a perceptible effect on prices or interest rates.

Mr. Gramley replied that if involuntary inventory accumulation became large enough over the next quarter or so to generate distress selling at the retail level, it was possible that there would be some price cutting. There already was some evidence of a similar development in the industrial raw materials area; as

inventories of materials had grown, demand had begun to ease and prices of sensitive raw materials had begun to decline. It was doubtful that there would be any significant impact on interest rates, however, unless the decline in the rate of inventory accumulation proved to be much larger than now envisaged. A shift to zero or negative inventory investment would, of course, imply a recession sufficiently severe to produce a decline in interest rates. The staff did not anticipate a decline in inventory investment of that magnitude. As he had noted earlier, however, on the basis of the current aggregate inventory-sales ratio relative to past relationships, the econometric model yielded more pessimistic results than shown in the judgmental projection.

Mr. Black observed that the historical relationships embodied in the equations of the model reflected conditions quite different from those prevailing at present.

Mr. Gramley agreed. He added that the staff had projected a more modest decline in inventory investment than suggested by past relationships because of the special factors in the current situation.

Mr. Sheehan said he strongly disagreed with the Committee members who believed the staff was unduly pessimistic about the economic outlook. Like Mr. Gramley, he thought any errors in

the staff projection were likely to be in the direction of under-estimating the magnitude of the downward adjustment.

From recent conversations with a number of businessmen, Mr. Sheehan continued, he had concluded that shortages of materials were much more isolated now than they had been 3 or 4 months ago. Certain grades of steel were still in short supply; for example, one fabricator in the Southeast reported that, while he could obtain sheet steel, he could not maintain a 2-day supply of welding material despite the use of expediters all over the country. On the other hand, steel reinforcing rods for concrete, which had been in very short supply earlier in the year, were now available. Several textile industry representatives reported that they were receiving numerous cancellations of orders, and people in both the textile and glass industries indicated that they were paying careful attention to their inventories.

It seemed quite likely to him, Mr. Sheehan observed, that the inventory correction would be greater than suggested in the staff projection. He also was quite worried about the outlook for sales of the 1975 automobiles, in view of the extremely sharp increases in auto prices and the declines in real income. He had had much the same pessimistic feeling about the economy last December, and while he had been wrong then and might be wrong again,

he still believed the economy might well be even weaker than the staff suggested.

Mr. Kimbrel noted that the directors of the Federal Reserve Bank of Atlanta had demonstrated considerably more pessimism during the last 10 days than at any time in the recent past. That change in attitude undoubtedly reflected the problems being encountered in their own industries, which included construction, mortgage financing, utilities, and textiles. Furthermore, a significant deterioration in public confidence in the banking system was suggested by an increase in the number of inquiries about FDIC deposit insurance, and about the procedures the FDIC followed when banks experienced difficulties. Those inquires typically did not involve any particular banks but were general in nature.

Mr. Kimbrel then noted that the staff was projecting an increase in the unemployment rate to the neighborhood of 7 per cent by next fall. He asked about the outlook for wages.

Mr. Gramley responded that the projections implied an increase in the average hourly earnings index at a rate of about 9 per cent over the projection period. It was assumed that the wage increases provided in large union contracts would probably be higher, but that growing unemployment in the competitive sectors, such as trade and services, would dampen the over-all rate of increase.

Mr. Holland noted that the high employment budget, which had been showing a moderate deficit for several quarters, was expected to shift to a rather sizable surplus. The staff projection indicated a change of about $10 billion between the third and fourth quarters of this year, and a further change of similar size in the first half of 1975. He asked what specific factors accounted for that increase in fiscal drag.

Mr. Gramley replied that the surplus was primarily a result of the anticipated restraint in Federal spending; no particular change in tax provisions was assumed.

Mr. Wendel noted also that inflation tended to increase Federal receipts relative to expenditures.

Mr. Gramley added that estimates of the high employment budget figures had to be interpreted cautiously, in view of the large role played by inflation in determining the final figures.

Mr. Holland then observed that the staff projections suggested a substantial shrinkage in profit margins from the fourth quarter on in nominal terms--and an even greater shrinkage in real terms. He wondered whether the decline in profits was expected to have an impact on capital spending within the projection period or whether longer lags were typically involved.

Mr. Gramley replied that, while declining profit margins had been an element in the staff's thinking in connection with the projection of developing weakness in some areas of business fixed capital investment, they did not play a major role. The major factors were the cutbacks in capital spending already announced by public utilities, the current high level of interest rates, and the accelerator effects in industries where demand factors were becoming more important, such as automobiles. No great weight had been given to cyclical changes in profit margins because business investment recently had appeared to be demonstrating less cyclical response than in the past. He thought that businessmen would recognize the relationship between the reduction in profits and the cyclical slowing of economic activity, and would base their investment decisions mainly on longer-run considerations.

Finally, Mr. Holland said, he had the impression that there were powerful cross-currents in the economy that were likely to persist for some time. He wondered whether cross-currents were becoming evident in price movements, despite the continuing rapid rise of the over-all indexes. Specifically, he asked whether there had been any significant reduction in the number of sectors of the economy that were generating price increases.

Mr. Gramley replied that prices of both food and fuels were now rising less rapidly than before. There also had been a

weakening in prices of sensitive industrial raw materials. With respect to the over-all averages, it appeared that inflation was slowing to a pace approaching the rate of increase in unit labor costs.

Chairman Burns commented that although the index of sensitive industrial raw materials prices had been declining irregularly, the total index of industrial materials prices had not declined.

Mr. Mayo remarked that he had hoped in connection with the next Federal budget that President Ford would be able to obtain the cooperation of Congress in restraining expenditures. In view of the reaction to the recent pardon of former President Nixon, he wondered whether President Ford would be able to mobilize the Congressional support needed for greater fiscal restraint.

The Chairman noted that he had observed increasing concern over the past few months about the Federal budget on the part of Congressmen in both political parties--a concern which undoubtedly reflected the attitudes of their constituents. The passage of budget reform legislation was one expression of the growing attention that Congress was giving to procedures that would facilitate better control over Federal spending. Because he thought the basic attitudes of the public about Government expenditures had not changed, he did not believe that Congressional support of the President's efforts to control spending would be appreciably diminished.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period August 20 through September 4, 1974, and a supplemental report covering the period September 5 through 9, 1974. Copies of both reports have been placed in the files of the Committee.

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

> In the brief interval since the last meeting of the Committee, the Trading Desk provided reserves a bit more readily, within a context of sustained restraint, responding to decisions made at the August meeting and to intervening evidence of relatively slow growth in key monetary aggregates. At the same time the Desk was mindful of the desirability of avoiding overly aggressive tactics that would risk market misinterpretation of the extent of System moves. Sharp fluctuations in interest rates, especially in the bill market, provided an unsteady backdrop to the Desk's reserve operations, posing a continual risk that the market would either over-interpret or under-interpret our intentions.
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> In the early part of the period, when bill rates were backing up sharply in the wake of the Treasury's announcement of a $2 billion sale of 10-month bills to raise new cash, the Desk made fairly strenuous efforts to move Federal funds below 12 per cent. The Federal funds rate declined 39 basis points to an average of 11.84 per cent in the August 28 week, helping to set the stage for an improved credit market atmosphere. A weaker view of the aggregates by the end of August called for revising the Desk's money market objective a little further, to a funds rate around 11-3/4 per cent, as estimated M_1 growth was falling somewhat below the lower end of the Committee's desired range. The further

decline in the funds rate, to an average of 11.64 per cent in the September 4 week, was brought about through reserve-providing market forces, which the Desk partially offset, against a background of brighter market sentiment.

In the final days of the interval, the Desk retained an objective of around 11-3/4 per cent even though the aggregates had softened further. Overt action to produce significant further easing would have risked a breakout of over-ebullient expectations, especially in the wake of the Board's announced reduction in reserve requirements on over-4-month CD's. Funds traded around 11-1/2 to 11-5/8 per cent on September 5 and 6, eliciting Desk action to absorb reserves, but the rate firmed unexpectedly to average around 11-7/8 per cent on Monday, September 9, despite an ample projected availability of reserves. This morning, trading was in the area of 11-3/4 per cent.

Based on their observations of System actions and press comments, most market participants seem to have concluded that a very modest modification of restraint has taken place. There remains a great sensitivity to further developments that might confirm, enlarge, or diminish the market's evaluations of a possible shift. At present, dealers seem disposed not to go overboard in bidding up prices. They have been up this path too recently. On balance, there seems to be a feeling that policy, at least as measured by the Federal funds rate, is more likely to ease off a bit further than to hold fast or tighten. Accordingly, the dealers are not too uncomfortable with their fairly sizable positions in bills, coupons, and agency issues.

The sharp swings in market sentiment over the period were most noticeable in the Treasury bill rate, which backed up dramatically in the first few days of the period. From auction averages of 8.85 and 8.90 per cent on the 3- and 6-month bills the day before the last meeting, the averages climbed to record discounts of 9.91 and 9.93 per cent on August 26. This past Monday, September 9, the rates were back down to 9.10 and 8.98 per cent. In the meantime, the Treasury's $2 billion, 10-month bill, which looked for a time as

> though it might not be covered in the auction, drew strong dealer bidding on August 28, selling at an average rate of 9.77 per cent. Dealers still hold a sizable supply of this bill.
>
> Treasury coupon issues followed a course similar to that of bills, but with less dramatic moves. Dealer inventories of coupon issues have come down only modestly in the past few weeks, but as noted, the dealers do not seem greatly concerned on this point. Reserve needs after mid-September may offer some opportunity for Desk purchases in this area.
>
> Elsewhere in the capital markets, yields on corporate and municipal bonds have risen on balance over the period in rather thin trading. While these markets have continued to function, their condition has remained fragile and they would not appear to be receptive to much of an increase in new issue volume. The stock market, meantime, has remained an area of deep gloom, broken by only occasional brief rallies, as market participants await more solid evidence that our economic ills are on the way to solution.

Mr. Holland asked whether it would be correct to infer from Mr. Sternlight's characterization of attitudes in the market that the risks were lower now than at other times that some further decline in the funds rate in the period ahead would produce a major rally in prices of securities. In his own view, market attitudes were more favorable than they had been for some time.

Mr. Sternlight replied that there was less risk of a major rally in response to the degree of movement in the funds rate that had recently occurred, but a larger decline could reawaken ebullient expectations. While market participants now were disposed to recall market developments of last February and of September 1973, such

memories could fade away if the participants observed what they considered to be a really significant movement in the funds rate and in System policy; the market was still vulnerable to misinterpretations of System actions.

In response to questions from Messrs. Holland and Mitchell, Mr. Sternlight observed that market participants watched the behavior of the monetary aggregates--as well as that of the funds rate--for clues to the course of monetary policy because they believed that the Committee gave a lot of weight to it. He believed that was true of the equity as well as the debt markets.

Mr. Axilrod added that over the past few months market participants might have changed their assessment of the weight to be given to the aggregates as an indicator of policy. One active and knowledgeable participant once had remarked that he took 6 weeks of stability in M_1 as a sure sign of a forthcoming rally in the bond market. Now, M_1 had been stable for 6 weeks, but there had been no signs of a rally in bond markets.

Mr. Eastburn asked whether a reduction even as small as a quarter of a point in the discount rate would be likely to touch off substantial declines in market rates and whether there was speculation in the market that the rate soon would be reduced.

In reply, Mr. Sternlight said the dealers had not been talking about the possibility of a cut in the discount rate. Even a small reduction would elicit some reaction, but whether it would provoke substantial declines in market rates would depend on the whole situation at the time and whether the market had reason to view the reduction as part of a pattern of System actions. For example, the recent Board action to remove the marginal reserve requirement on large time deposits maturing in 4 months or more could have touched off dramatic changes in rates, but the market interpreted the actions--as it was encouraged to do--as a rather modest move.

> By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period August 20 through September 9, 1974, were approved, ratified, and confirmed.

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

> Of the three alternatives[1] presented to the Committee today, alternative B is generally consistent with the projection of the economic outlook presented by Mr. Gramley, assuming that the 5-3/4 per cent annual growth rate for M_1 shown in that alternative were to be continued throughout next year. Alternative A is

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

moderately more expansive, characterized by a 6-1/2 per cent annual rate of growth in M_1, while alternative C represents a less expansive policy and includes a 5-1/4 per cent rate of growth in M_1. Alternative C assumes unchanged money market conditions, while alternatives A and B presume varying degrees of easing in money market conditions, and in interest rates and credit conditions more generally, over the months immediately ahead.

The recent shortfalls in M_1 growth have brought the level of M_1 sufficiently below the growth path adopted at recent meetings so as to require some further easing of money market conditions to encourage a move back toward path. The extent of ease would depend on how promptly, if at all, the Committee may wish to compensate for the shortfall. Alternative C does not contemplate compensating for the shortfall at all, while alternatives A and B do make it up, in one case by winter and in the other by spring.

Whether the recent shortfall reflects long-lasting factors, or is a temporary aberration that may be followed in the coming months by an overshoot that occurs more or less naturally (i.e., without significant declines in the funds rate) is, of course, a critical question. Earlier, we had assumed such an overshoot would occur, perhaps in September. It still may, but the fragmentary figures for early September do not suggest it.

We have attempted to determine what, if any, special factors may have been at work retarding M_1 growth in the summer, given the interest rates that have prevailed. There are a few. One is the behavior of foreign official demand deposits. They have been declining over the past 2 months, and account for about 1 percentage point, at an annual rate, of the 2-month July-August slowdown in M_1 growth. The rise in U.S. Government deposits from June to August may be another special factor that retarded M_1 growth, although I hesitate to mention it because our statistical evidence on the relationship between U.S. Government deposits and M_1 is, in my view, weak.

Another factor that might be mentioned, and a more basic economic one, is the possibility that during

the summer the public became even more conscious than before of the eroding impact of rising prices on the real value of their cash balances. In the short-run consumers could well have attempted to protect themselves by moving into attractive interest-earning assets that were becoming available. It is also possible that in August cash was drawn down to meet part of the downpayments on auto purchases, which expanded as consumers acted to beat the price increases.

If these special factors have been affecting M_1 growth, there would be room for resumption of greater growth in the months ahead, when U.S. Government deposits are projected to decline and when, as may occur, foreign official deposits stop declining. We have allowed for this to some extent in our projections, which do assume a substantial pick-up in growth after September. But it is quite possible that we may not have allowed for enough. Thus, the Committee may wish to consider raising the upper end of the 2-month, September-October ranges of tolerance, if it wishes to permit a somewhat more rapid M_1 growth in the short-run, should it develop at the Federal funds rate specified.

One final point should be made, however. Shortfalls in M_1 growth may also reflect a weakening of economic activity relative to staff projections. The longer that shortfalls in M_1 growth continue, given particular money market conditions, the more likely are they to reflect a weakening in transactions demands for cash, and hence in GNP, as compared with expectations. This line of reasoning argues for permitting interest rates to decline as reserves are supplied in an effort to sustain M_1 growth. I would point out, however, that in 1973 we had a third quarter in which M_1 showed no growth, but this was followed by a fourth quarter in which it grew by 9 per cent, even though interest rate declines were relatively very modest. Thus, at the present time, one option for the Committee to consider is whether it wishes to await somewhat more sustained weakness in M_1 before contemplating a policy that permits relatively sizable interest rate declines.

Mr. Morris remarked that in the second half of 1973--when a quarter of no growth in M_1 was followed by a quarter of substantial growth, as noted by Mr. Axilrod--economic activity was expanding, and he was doubtful that the experience of that period was relevant to the present situation.

In response, Mr. Axilrod commented that nominal GNP was projected to expand at an annual rate of about 8.5 per cent in the second half of this year, not far below the rate of about 10.5 per cent in the second half of 1973. However, real GNP was projected to decline in the current period while it had expanded somewhat in the earlier one, and therefore, the behavior of the public's transactions demands for cash might differ this time.

Mr. Black asked whether a lagged response to the upswing in interest rates earlier in the year might not be another possible cause of the recent weakness in M_1 growth. That cause, coupled with a shortfall in transactions demands for cash, might result in continuing weakness in M_1 growth.

Mr. Axilrod replied that the lags in the relationship between interest rates and monetary growth were both uncertain and variable. It was possible that the recent

weakness in M_1 growth reflected a shorter-than-normal lag in the response to last summer's rise in interest rates. If that were the case, however, resumption of higher rates of growth also would be likely to occur sooner than would otherwise be expected.

Mr. Hayes observed that in the perspective of developments over the past few years he found it difficult to see any shortfall in M_1 growth. M_1 grew at an annual rate of 8.7 per cent in 1972, of just over 6 per cent in 1973, and of about 5.25 per cent in 1974 to date. He regarded that gradual slowing in the growth rate as appropriate in the highly inflationary conditions that the System had been trying to combat.

Mr. Axilrod responded that in his statement he had not attempted to judge the appropriateness of any of the M_1 growth paths presented in the blue book.[1/] He merely had pointed out that the August base from which alternative growth paths were projected was below the growth paths adopted by the Committee at recent meetings and, consequently, that a 5-1/4 per cent growth path projected from the August base resulted in a

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

lower level of M_1 in the second half of this year than had been anticipated by the Committee.

Mr. MacLaury asked whether there might be any validity to another possible explanation for the recent slowing down in M_1 growth--namely, that banks had become sufficiently concerned about the state of their own liquidity and that of the banking system as a whole that they were tightening up their lending policies without regard for the availability of reserves.

Mr. Axilrod said he would not exclude that possibility. If banks had been tightening up their lending policies to that degree, growth in nominal GNP would be restrained and growth in M_1 would be held down. As he had observed in his statement, the longer shortfalls in M_1 growth persisted, given particular money market conditions, the more likely they were to reflect a slower-than-expected rate of growth in GNP.

After recessing briefly, the Committee reconvened with limited staff attendance. In addition to the members, alternate members and other Reserve Bank Presidents, the following were present: Messrs. Broida, Altmann, O'Connell, Axilrod, Bryant, Gramley, and Sternlight.

Also present were:

Mr. Coombs, Special Manager, System Open Market Account

Mr. Coyne, Assistant to the Board of Governors

Before this meeting there had been distributed to the members of the Committee a report from the Special Manager of the System Open Market Account on foreign exchange market conditions and on Open Market Account and Treasury operations in foreign currencies for the period August 20 through September 4, 1974, and a supplemental report covering the period September 5 through 9, 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:

> Despite some strong German trade figures and disappointing U.S. figures for August, the dollar has firmed up considerably since the last meeting of the Committee. Interest rate differentials continue to favor New York and the Euro-dollar market as against Frankfurt, and the failures of two more small German banks have probably resulted in further outflows of short-term funds from Germany.
>
> As the mark came on offer we cleaned up the $55 million residual of our mark debt and added roughly $60 million to balances. The mark is now trading only slightly below its central rate. The German Federal Bank has been intervening fairly heavily to keep it from declining further, and I am hopeful

that they will continue to do so. Before making heavy additions to our mark balances, however, I should like to see a firmer expression by the German Federal Bank and the German Government as to their exchange rate policy.

Meanwhile, the mood of apprehension in both the exchange market and the Euro-dollar market has deepened, with particular concern now being expressed that the Euro-dollar market and perhaps the New York market as well are approaching the limits of their capacity to recycle Arab oil money back to the deficit countries. There is much worrying by responsible people that the near-saturation of the Euro-dollar market both as a recipient and a lender of funds may bring about sudden heavy flows of oil money into the U.S. Government securities market while the supply of dollar liquidity elsewhere will equally suddenly dry up. In effect, we are getting back to the market psychology of last winter which produced such a sharp run-up in dollar rates, but with a real possibility this time that some of these fears may actually materialize.

Chairman Burns asked why Mr. Coombs thought it would be desirable for the German Federal Bank to continue to intervene.

Mr. Coombs replied that he was concerned about the risk of sizable declines in exchange rates against the dollar of a number of major foreign currencies, in a repetition of the pattern of last year when declines on the order of 20 per cent were recorded. In his judgment, that sharp fall--and subsequent rise--in exchange rates had served no useful

purpose; on the contrary, it had contributed to present problems by fostering a casino-like atmosphere in exchange markets and by augmenting domestic inflation. The current situation was marked by many imponderables; until more was known about the fundamentals, he thought it would be helpful to have a reasonable degree of stability in exchange markets.

In reply to a question by Mr. Winn, Mr. Coombs said the flows of oil funds to the United States in the coming period might be so large that the U.S. market would have difficulty accommodating them.

Mr. Morris asked whether modest declines in U.S. interest rates would be helpful in stabilizing the situation.

Mr. Coombs replied that he thought not. U.S. Government securities were an attractive investment to the oil producers not so much because of the interest rates they carried but rather because of their high credit standing.

Chairman Burns remarked that the source of the difficulty lay in the massive volume of funds being accumulated by the oil-exporting countries. The problem was likely to be unmanageable unless the flows to those countries were reduced by a decline in the price of oil.

Mr. Mitchell said he assumed that investment outlets could be found for funds of OPEC countries so long as those countries were prepared to bear the credit risks involved. He would be opposed to any program in which the risks were borne by institutions which the United States would underwrite.

Mr. MacLaury remarked that the basic question seemed to be whether the U.S. Government should undertake to resolve the problem--specifically, whether this country should offer a recycling facility for oil money.

Chairman Burns observed that that was the outcome a number of European countries no doubt would like to see. If most of the funds of the OPEC countries were invested in the United States, U.S. commercial banks would be able to recycle only part of them because the number of creditworthy borrowers was limited. When a financial solution was found to be impossible, a political solution was likely to be sought; some Europeans were probably already envisioning a grandiose new Marshall Plan, involving tens of billions of dollars. In his judgment, there was no chance at all that the Congress would agree to any such plan.

Another plan that was likely to be discussed actively in the weeks ahead, the Chairman continued, involved the establishment of a new and much larger recycling facility in the International

Monetary Fund. Under the present facility, which was somewhat more than $3 billion in size, the countries supplying funds received a below-market interest rate of 7 per cent, and borrowers were charged a below-market rate. The proposed new facility would be much larger--perhaps $10 to $20 billion--and it would be designed to attract OPEC funds by offering returns equal to market interest rates. Such a facility would not pose any immediate issues for the U.S. Congress unless it was proposed to assemble funds not only from the OPEC countries but from the United States also. However, the IMF was likely to incur losses on the recycling operations, and it might be presumed by other countries that the United States and West Germany would be willing to make up such losses. In his judgment any such presumption would be highly questionable.

Mr. Hayes said he fully agreed with the thrust of the Chairman's remarks, including the view that Congress was unlikely at present to approve a plan under which the United States would act to resolve the oil financing problem. It appeared, however, that the OPEC countries wanted to invest large sums directly in this country. Eventually, therefore, U.S. action to facilitate recycling might be necessary in order to avert a catastrophe. In light of that possibility, he wondered whether it might not

be desirable for the Administration to undertake an educational process now.

Chairman Burns remarked that he, for one, would not want to undertake such an educational process. Other solutions would have to be found. In the short run, the OPEC countries could ameliorate the problem they had created by lending directly to the countries experiencing great difficulty in financing oil imports; in the longer run, the problem should be resolved by a reduction in the price of oil.

Mr. Holland observed that it obviously was not in the U.S. national interest to have attractive returns offered on any securities the OPEC countries acquired directly from the Treasury. It also would be desirable to discourage U.S. banks from offering high rates for OPEC funds placed with them.

Mr. Wallich said he would agree that the best solution to the immediate problem would be for the OPEC countries to make direct loans to the countries having difficulty in financing oil imports. If that was not feasible, he thought the next best hope lay in the IMF. As a matter of practice, the IMF so far probably had never reached the conclusion that it had incurred a loss because a borrowing country had defaulted; typically, when

a borrower was unable to make scheduled payments, the debt was renegotiated and the repayment period stretched out.

Chairman Burns remarked that the procedure Mr. Wallich had described was typical of the past. However, there was now a new financial environment in which everything was on a much larger scale.

Mr. Coombs noted in that connection that payments to oil producers in September alone would come to $10 billion. To his mind, the best solution by far would be for the OPEC countries to offer direct credits to the oil-importing countries.

Mr. Hayes said it was important to bear in mind that, regardless of the degree of recycling, the poorer oil-importing countries would probably find the burden of debt service unbearable.

Mr. Wallich noted that the only way in which debts for oil imports--or even the interest on such debts--could really be paid in fact was by exports of goods and services from oil-importing to oil-exporting countries. So long as the oil exporters were accumulating financial claims, it mattered little whether they were charging for oil or charging interest; the sums involved simply had to be added to the total debt.

Mr. MacLaury asked whether it might not be better to use the World Bank rather than the IMF as a loan-pooling facility, since the problem was not of a short-run nature.

Chairman Burns said there was merit in that suggestion. One problem, however, was that the World Bank customarily made loans to the so-called developing nations, whereas the countries experiencing difficulty in financing oil imports included some of the strong industrial nations.

> By unanimous vote, the System open market transactions in foreign currencies during the period August 20 through September 9, 1974, were approved, ratified, and confirmed.

The Chairman noted that at the September meeting of central bank governors in Basle, from which Messrs. Wallich and Coombs had just returned, a communique had been issued relating in part to assistance to Euro-market financial institutions facing temporary liquidity problems.[1/] He invited Mr. Wallich to comment.

Mr. Wallich observed that the communique was written with the understanding, conveyed by those central bankers present who had also been at the Paris meeting of finance ministers and central bankers, that the finance ministers were expecting the governors' meeting at Basle to come forward with a statement on the lender-of-last-resort function. The communique contained relatively little detail about central bank responsibilities as lenders of last resort in the Euro-markets and it did not

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1/ A copy of the communique is appended to this memorandum as Attachment B.

commit any particular country. However, there was some forward movement on that subject at the meeting, particularly in connection with London institutions. Originally, the Bank of England representatives had taken the position that the responsibility to act as lender of last resort to subsidiaries and consortium banks in London should be assumed by the central banks of the countries in which the parent institutions were located. The Federal Reserve representatives had urged instead that in the first instance the parent institution should be responsible for helping the London subsidiary, and that if additional assistance were needed the Bank of England, as the host country central bank, should help the subsidiary, and the central bank of the parent institution should help the parent. The Bank of England representatives then advanced a new proposal under which the Bank would hold formal discussions with every foreign subsidiary and consortium bank in London, numbering perhaps 60 institutions, in which each would be asked for a clear statement that the parent institution--in the case of consortium banks, the various share-holding banks--would provide assistance in the event of need. They expected to get positive replies, on the grounds that international banks could not afford to walk away from their subsidiaries, but they implied

that they might be prepared to ask some banks to withdraw if satisfactory statements were not forthcoming.

Mr. Wallich remarked that the situation could be improved under that procedure because the parent institutions would provide support in dealing with problems of solvency as well as of liquidity, whereas central banks had to limit operations as lenders of last resort to liquidity problems. If all went well, the program would represent a substantial step forward. If not, the situation would be much as it was now; some gap, although perhaps not a very serious one, would exist in the back-up facilities available to Euro-market institutions in London.

Chairman Burns said he was not persuaded that the proposed procedure was a great step forward. While U.S. parent institutions presumably would agree to provide support to their London subsidiaries, in the event of need they themselves would turn to the Federal Reserve for support. Thus, the Bank of England would carry no responsibility, even though the failure of a London subsidiary might have repercussions throughout the British financial community.

Mr. Wallich observed that even if the Bank of England were to agree to provide the back-up, the Bank might well have to draw on its swap line with the Federal Reserve to obtain the dollars needed.

Chairman Burns expressed the view that the intermediate step involving the Bank of England would serve a useful purpose.

Mr. Mitchell noted that in one recent case, involving the London subsidiary of a U.S. bank, the Bank of England had cooperated with the System in persuading the parent bank to extend the necessary assistance. He thought that had been an excellent test of the Bank's good will in resolving such problems.

Mr. Wallich agreed. The sums involved in that case had been relatively small, but that was likely to be true generally. For one thing, the large institutions for the most part were branches, and there was no question but that a U.S. bank would have to stand behind its branches. Moreover, the main subsidiaries were affiliated with very large U.S. banks; if the latter had to use a few tens of millions of dollars in a rescue operation they might have to come to the discount window, but their over-all position probably would not be changed a great deal. Problems were most likely to arise with smaller banks that had subsidiaries with deposits of a few hundred millions, but not billions, of dollars. To put the situation in perspective, he might note that the total of deposits in foreign branches of U.S. banks was some $140 billion, whereas only $11 billion was held in foreign subsidiaries of U.S. parents, and of that only $2.6 billion was held in subsidiaries in London.

Mr. Wallich then said he might take this opportunity to comment on two other developments in Basle. First, a representative of the Bank of Italy had expressed unhappiness over the decision by U.S. national bank examiners to classify loans made by U.S. banks to borrowers in Italy in a "special mention" category--a decision which he thought had resulted in deposit losses by Italian commercial banks. Mr. Wallich added that the examiners' action had in fact originated from an effort to coordinate the treatment of Italian loans in various examining districts where that treatment had diverged.

Chairman Burns remarked that he had been aware of the unhappiness of the Italian authorities on that score. While their attitude was understandable, he believed that the deposit losses to which they pointed were the result not of the examiners' decision but of the cloud that had been surrounding Italian financial markets for some time.

Mr. Wallich then observed that, as indicated in the communique, the discussion at Basle also had been concerned with the rules and regulations governing foreign exchange positions of banks. The BIS had now collected data on such regulations, as well as on certain related subjects, for a number of major countries. It was proposed at Basle that the various countries might attempt to coordinate their regulations, or at least that the authorities

in each country should carefully study the regulations of other countries with a view to strengthening their own if they concluded that they were too weak. While he (Mr. Wallich) had argued against coordination, he had suggested that contacts among examiners be developed to improve understanding of the technical problems involved. He believed that much could be learned by the examiners of particular countries, and he hoped that mechanisms could be worked out for exchanges of information and perhaps of personnel.

Mr. MacLaury asked whether studies also were under way of regulations governing Euro-dollar liquidity positions--that is, of relationships between Euro-dollar assets and liabilities.

Mr. Wallich replied affirmatively. He noted that some countries had rules about matching Euro-dollar maturities while others did not. Also, of course, there were regulations concerning more general liquidity relationships and capital ratios. Some of the continental European countries had much firmer legal guidelines on such matters than were applied in the United States. On the other hand, it was his impression that the United States had by far the best approach to bank examination in terms of the development of detailed information about the position of individual banks.

In reply to a question by Mr. Coldwell, Mr. Wallich said the European authorities were now beginning to concern themselves

with the question of open positions; the Germans, for example, had just introduced a tighter rule on that subject. The Bank of England, which in the past had not even had a bank examination department, had recently established such a department.

Chairman Burns noted that the Federal Reserve staff had been asked to study the possible need for legislation or regulation governing the degree of foreign exchange exposure of individual commercial banks.

The Chairman then asked whether Mr. Coombs had any recommendations for the Committee.

Mr. Coombs said he would recommend renewal, if necessary, of two System swap drawings on the National Bank of Belgium, totaling $31.8 million, that would mature on October 18 and 25, respectively. Because that swap line had been in continuous use for more than a year, express authorization by the Committee was required if the drawings were to be renewed. It might, however, prove possible to purchase the francs needed to repay the debt before the drawings matured.

Mr. Mitchell asked whether it would be agreeable with the U.S. Treasury for the System to make such purchases of francs.

Mr. Coombs expressed the view that the Treasury would not object to the System's accumulating Belgian francs in its balances for possible subsequent use in repaying debt. However, the exchange rate for the franc was now only about 2 per cent above the central rate. He would be inclined to postpone purchases of francs until the rate had declined to the central rate, which might well happen within the next week or two.

In reply to a question by Mr. Holland, Mr. Coombs said his main reason for wanting to defer purchases of Belgian francs was to avoid the need for a potentially futile debate with the Belgians about sharing losses on System repayments. As the members knew, the Treasury had introduced the question of loss-sharing in connection with System repayments on both its Belgian and Swiss franc swap debts, but no final agreement on the matter had been reached as yet with the Belgians. The issue would not arise if the francs needed were acquired at the central rate.

Mr. Holland said he would favor making strong representations to the Treasury that the System should repay all of its outstanding debt to the Belgians even if no loss-sharing arrangement had been negotiated. In his judgment the advantage sought

through loss-sharing, in terms of saving money for the United States, was far outweighted by the disadvantage of permitting a 3-year old debt to remain on the System's books any longer--particularly at a time when the System was preaching the importance of good credit practice to others.

Mr. Coombs observed that the Swiss, who had already agreed in principle to a loss-sharing arrangement in connection with System repayments on its Swiss franc swap debt, might well be disturbed if the System incurred losses on its Belgian franc debt without pressing for an equivalent arrangement.

In reply to a question by Mr. Sheehan, Mr. Coombs said the System's total swap debt to the Belgians was $262 million at the moment. Negotiations currently were under way to write up the amount to $316 million, to reflect the devaluations of the dollar of December 1971 and February 1973.

Mr. Wallich remarked that he reluctantly supported Mr. Coombs' position. Earlier, he had felt that the System should repay its debt to the Belgians even without an agreement on loss sharing, since it was continually reminding its swap partners of the short-term nature of drawings on the swap network. However, in light of the considerations Mr. Coombs had mentioned,

and in light of the distance already covered in the discussion of loss sharing, he now believed that an effort should be made to avoid a loss on repayments of the debt to the Belgians.

Chairman Burns suggested that the Committee defer further consideration of the question Mr. Holland had raised for a brief period, to see whether Mr. Coombs' hopes about movements in the Belgian franc exchange rate were realized.

Mr. Mitchell proposed that the question be deferred until the next meeting.

Mr. Holland said he would be prepared to accept such a postponement. He planned to press the issue at the time of the next meeting if it had not been resolved by then.

The Chairman remarked that Mr. Holland could expect support from other members in that event.

> By unanimous vote, renewal for further periods of 3 months of two System drawings on the National Bank of Belgium, maturing on October 15 and 18, 1974, respectively, was authorized.

Mr. Holland then said he would like to raise another question in connection with the System's swap debt to the Belgians. He understood that the FOMC Subcommittee, to which the full Committee had delegated authority to resolve problems relating to

the terms of repayment of that debt, had recently decided not to ask the Treasury to use some of its SDR's if necessary to obtain the francs required to liquidate the debt, in accordance with the terms of a 1968 letter from Treasury Secretary Fowler to Chairman Martin. He thought it would be desirable for the full Committee to be informed at some stage of the reasons underlying that decision.

Mr. Mitchell suggested that that matter be scheduled for discussion by the Committee at its next meeting.

There was general agreement with that suggestion.

Chairman Burns then called for the Committee's discussion of monetary policy and the directive, and he suggested that the members address themselves to three questions. They might consider, without regard to the particular role of monetary policy, what might be the desirable course of economic activity over the next 6 to 9 months--whether, in the present circumstances, it would be better if activity remained near the current level, with any further decline held in check, or whether it would be better if activity revived promptly and recovered significantly. Secondly, the members might comment on the Committee's longer-run targets for the aggregates, focusing on M_1 for the sake of simplicity.

The blue book presented three alternatives: an annual rate of 5-1/4 per cent--the rate that had been adopted at the last three meetings--and rates of 5-3/4 and 6-1/2 per cent. Finally, the members might express their preferences with respect to the short-run specifications and the language of the directive.

The Chairman added that earlier in the day the Board had turned down one Reserve Bank's application to reduce the discount rate from 8 to 7-3/4 per cent. The Board had taken that action because the discount rate was well below market interest rates and because a reduction at this time would be an excessively strong policy signal.

Mr. Hayes observed that he was acutely aware of the growing demands that the System relax its policy stance to some degree, but he thought it would be a serious mistake to yield to those demands. First, inflation was real and immediate, and inflationary expectations continued unabated, whereas unemployment--though expected to reach higher levels next year--was still rather low. Second, the probabilities favored a prolonged period of little or no growth but not a severe recession. Third, the Committee had long recognized that a relatively extended period of monetary restraint would be needed to bring substantial progress against inflation. Fourth, fiscal

restraint was not yet by any means assured, and a relaxation of monetary policy in advance of its realization could be taken as an implied reduction in the need for fiscal restraint. Fifth, from a global standpoint, inflation was still a greater problem than the risk of recession, and success in combatting inflation in this country would have world-wide benefits. Sixth, to the extent that liquidity problems existed, they could and should be dealt with through specific measures rather than a broad shift in monetary policy. Seventh, the market was all too likely to seize upon any modest easing move as the beginning of a major policy change. Such over-reaction had occurred several times in the past year, and it would be desirable to avoid another such occurrence. The market had already shown some tendency to react in that way to recent developments, including the removal of the marginal reserve requirement on large time deposits maturing in 4 months or more, although the reaction had been modest.

Against that background, Mr. Hayes continued, he would rather see economic activity remain near its current level than turn up sharply. With respect to the longer-run targets, he would retain a 5-1/4 per cent rate for M_1, as under alternative C. To raise the target to 5-3/4 per cent, in accordance with alternative B, would signify a clear easing of policy in terms of an immediate decline in the

Federal funds rate and in other market interest rates, and that would not be appropriate. Maintenance of the 5-1/4 per cent rate would not be too restrictive. In the event that the economy proved to be weaker than he now expected, the growth in the money supply automatically would become more accommodating than it now appeared, and the rate of monetary growth would not need to be much more than 5-1/4 per cent. Even the more pessimistic projections suggested that pronounced weakness in activity was several quarters ahead, and therefore, there would be time to consider the necessity of changing the longer-run targets.

Consequently, Mr. Hayes concluded, he was in favor of maintaining about the current policy of firm restraint. The slowdown of growth in the monetary aggregates over the past 2 months was all to the good, and he was satisfied with the projections of monetary growth based on the current levels of short-term interest rates. In the event that other economic policies were directed more toward restraining inflation, as would be desirable, his views on monetary policy might change. Accordingly, he favored alternative C, although he could be persuaded to shade downward a little the 10-3/4 to 12-3/4 per cent range for the funds rate shown under that alternative. Concerning the discount rate, it was wise not to make a change in the present circumstances.

Mr. Mayo remarked that everyone would like to see an upturn in economic activity over the next 6 to 9 months. However, the Committee had no real alternative but to pursue a policy that maintained a restrictive stance against inflation. Consequently, he believed that over the 6- to 9-month period it would be better if economic activity remained near the current level. The Committee did have a responsibility to check any further declines in activity, and perhaps of even greater importance, it had a responsibility with respect to the liquidity situation. Many bankers in his District were saying that they could get through this period basically unscathed, but they were fearful that many of their customers could not--that many businesses could not bear the currently high interest rates for more than a limited period.

Accordingly, Mr. Mayo said, he favored alternative B. That alternative represented a policy that was still very restrictive, but one that allowed for some shading downward of the Federal funds rate. A very slight easing--accomplished very delicately--was desirable, and the alternative B range of 10 to 12 per cent for the funds rate was appropriate. The Manager should be instructed to take advantage of easing tendencies in the market and to avoid reversing those tendencies to the extent that had been felt necessary during the past month. He had no objection to raising the longer-run target for M_1 to 5-3/4 per cent. As he interpreted the record,

the Committee in reality had been pursuing a 5-3/4 per cent growth path since January 1974, and it would be desirable to acknowledge the fact. The pursuit of such a rate of growth would not constitute a ratification of inflation. Concerning the discount rate, he would not recommend a change in the present circumstances. To reduce the discount rate when it was already so out of touch with market rates would merely emphasize that it was not a useful policy instrument at present. But to the extent that a reduction did have an announcement effect, it would be an improper one at this time.

Mr. Coldwell commented that in his judgment at this time a major depression in this country was unlikely. However, he was concerned about the possibility of additional recessionary pressures and believed that it would be desirable if further declines in economic activity were stemmed. He would prefer economic activity to remain near its current level for about 3 months--not for as long as 6 to 9 months--and then to start on a course of real improvement. Inflation was still the biggest problem, and it was with respect to that problem that monetary policy could make its greatest contribution. Thus, he would not be inclined to rush away from a policy of restraint at the first signs that it was having an effect; he would prefer a delicate move toward ease, following market rates down if they were inclined in that direction. Monetary growth had not fallen short

of the targets he had had in mind, and consequently, he saw no need to endeavor to make up shortfalls.

Since he preferred to maintain a fairly taut position, Mr. Coldwell said, he favored specifications between those of alternative B and C--including a longer-run target of 5-1/2 per cent for M_1 and short-run ranges of tolerance of 3 to 5 per cent for M_1 and 10-1/2 to 12-1/2 per cent for the Federal funds rate. He could accept the language of either alternative B or C, although he would prefer an amended version of alternative C that would read "the Committee seeks to maintain stability in bank reserves and money market conditions consistent with modest growth in monetary aggregates." Regarding the discount rate, he believed that the Board's action in disapproving the application for a reduction was appropriate; a reduction at this time would have been inappropriate both because the rate was so much below market rates and because the announcement effects would have been excessively strong.

Mr. Francis observed that no matter what course of economic activity Committee members might wish to see, a move toward ease in monetary policy over the next quarter or two was likely to increase inflationary pressures rather than to stimulate a significant gain in production. If the Committee maintained the longer-run target for monetary growth that it had been pursuing, in time economic

activity would turn up. Consequently, he preferred the longer-run monetary growth of alternative B for the balance of this year, but in the first quarter of next year, he would prefer the target of alternative C. He could accept the language of alternative B.

Mr. Eastburn commented, with respect to the Chairman's first question, that he preferred to see economic activity remain near its current level for a period of time, that the only way the Committee could achieve its objective of getting inflation under control was to maintain a relatively slow rate of growth in activity. A period of 6 to 9 months of little or no growth might be too long, but a judgment about that could be made later on. He would feel more comfortable with his position if there were some assurance that the Administration would take such actions as providing employer-of-last-resort facilities and liberalizing unemployment compensation.

Mr. Eastburn remarked that the Committee had been endeavoring to reduce the rate of monetary growth and that it needed to maintain its focus on the longer-term goals. That did not mean, however, that the rate ought to be reduced inexorably until inflation was conquered or, alternatively, that it should be increased precipitously as soon as economic growth slowed. In general, his target was an M_1 growth rate between 5-1/2 and 6 per cent, but the

decision concerning the appropriate rate for the next 7 months involved some complications. With that decision in mind, he had distributed a chart of money supply target paths, which he had found useful.[1/]

Continuing, Mr. Eastburn said the long solid line on the chart showed a steady 5-3/4 per cent growth path throughout 1974 and the first quarter of 1975. The upper dashed line on the chart represented the 5-1/4 per cent growth rate from June to December of this year, which the Committee had adopted at the July meeting; that rate implied M_1 growth of 6.2 per cent from December 1973 to December 1974. By the time of the August meeting, the money supply data had been revised downward, with the result that the 5-1/4 per cent path adopted in August implied--as shown in the chart--growth of about 5-3/4 per cent in 1974; in terms of the actual level of M_1, the August decision represented a tightening of policy. The lowest line on the chart showed the 6-1/4 per cent rate of growth that M_1 would have to follow from the August base through March 1975 if a 5-3/4 per cent rate were to be achieved for the whole period from December 1973 to March 1975. Thus, a 6-1/4 per cent growth rate would be required over the 7 months from August

1/ The chart is appended to this memorandum as Attachment C.

to restore M_1 growth to the 5-1/2 to 6 per cent range that he preferred.

Mr. Eastburn said the analysis would lead him to favor alternative A, because it called for a 7-month growth rate of 6-1/4 per cent. However, such a shift in the longer-run target at this time would imply a more drastic change in money market conditions than he desired. Therefore, he would recommend a target of 6 per cent, which was part way between alternatives A and B. He would specify the funds rate range of alternative B, with the understanding that the rate would be moved down gradually within the range. The language of alternative B was acceptable.

Chairman Burns remarked that he might make a few general comments at this point. With regard to the first question he had put to the Committee, he would not wish to see a prompt recovery in economic activity. If recovery began promptly, economic activity would turn up at a time when inflation was continuing at a two-digit rate. The result--if business cycle history was any guide--would be an acceleration in the rate of inflation in the months immediately ahead. At the same time, he believed that somewhat lower interest rates had become appropriate and truly desirable in view of the tensions existing in financial markets and of the dangerously depressed conditions in the stock exchanges. And if the staff

analysis was correct, somewhat lower interest rates were consistent with moderate rates of growth in the monetary aggregates in the period ahead.

Mr. Kimbrel commented that he agreed with what the Chairman had just said. The public was beginning to be convinced of the System's determination to fight inflation, and he would hate to see any actions now that would be interpreted as a significant easing and that could be mistakenly taken to mean that the System already anticipated success in its efforts. The result of such actions might well be that the System would fail to accomplish its objectives, especially since the support of fiscal policy still was so uncertain. At the same time, he would be distressed to see any further decline in the economy; he hoped that activity would remain close to its present level. Toward that end, he would favor a longer-run M_1 target of 5-1/2 per cent, which was mid-way between alternatives B and C. Otherwise, he favored alternative B, except that he would not want the funds rate to decline by more than one percentage point between now and the next meeting and would not object if it moved up for a short period. Accordingly, he would specify a somewhat higher and narrower range for the funds rate than shown under alternative B--namely, a range of 10-3/4 to 12-1/4 per cent.

The Chairman then asked Mr. Gramley for his policy recommendations.

Mr. Gramley observed that the staff projections of GNP were based on the longer-run path of monetary growth of alternative B, and those projections suggested that economic activity would decline significantly in the period through the second quarter of 1975. In his judgment, the risk of error in the projections was on the side of underestimating the degree of weakness ahead. Therefore, he believed that the time had come to make a rather significant move toward easing monetary policy. He would not be concerned that the financial and business communities might infer that the System had given up the fight against inflation, because he believed that such an inference would be drawn only if the System acted in a manner that seriously threatened a rejuvenation of inflationary forces. An easing of policy along the lines of alternative A would not create such a threat and would not lead to misinterpretations of the System's policy stance.

Mr. Wallich remarked that economic developments--apart from financial market developments--in the period immediately ahead had already been largely determined by past actions of the System, and that policy actions in the immediate future would influence the course of economic activity early next year, perhaps in the spring.

He would like to see a slow rise in real GNP, more or less maintaining a constant per capita real GNP, which would mean an annual rate of growth on the order of 2 per cent. The rate of unemployment would rise, but the rise would not be so fast that the System would be subjected to pressures to reverse policy completely. There was a certain amount of slack in the economy that could be tolerated, and it would be desirable to spread it over a period of time; in other words, the country might tolerate a greater aggregate loss of manhours under a policy that resulted in moderate unemployment over time than it would under a very restrictive policy that quickly generated much higher unemployment. There was a danger now that unemployment would rise sharply, and it was surprising that the rise had not already been greater.

Continuing, Mr. Wallich said he favored a policy for the period ahead that would bring about an upturn in real GNP by some time early next year but that at the same time would avoid the typical recovery in which actual output rose more rapidly than potential output and the rate of unemployment declined. That would lead him to choose either alternative A or alternative B. Because of the high rate of inflation, the Committee ought to modify its longer-run target somewhat to take account of some part--but by no means all--of the rate of increase in prices. At the same time,

it was critical to avoid a decline in the Federal funds rate to an extent that would give a false signal. If people inferred that the System had changed its policy completely, control of the situation would have been lost. Consequently, he would accept alternative B, with a 10 to 12 per cent short-run range of tolerance for the funds rate, although he would prefer a slightly faster rate of monetary growth than specified under that alternative.

Chairman Burns commented that it was extremely important to avoid giving a false signal, and for that reason, he would prefer a funds rate range of 10-1/2 to 12 per cent to one of 10 to 12 per cent, as indicated under alternative B. The mid-point--11-1/4 per cent--then would be 3/4 of a percentage point below the mid-point of the range adopted at the last meeting.

Mr. Sheehan remarked that he was in general agreement with Mr. Wallich's conclusions. He would hope that economic activity would remain near the current reduced level--or, ideally, decline another 1 per cent--until about the middle of next year and then turn up and expand at a rate not above 2 per cent for an indefinite period. He held that position because inflation was intensifying, rather than abating, and he was not convinced that the rise in the GNP implicit deflator would be down to a 7 per cent annual rate by the middle of next year, as suggested by the staff projections. He

could accept an increase in the unemployment rate into a range of 6-1/2 to 7 per cent by the middle of next summer and hoped that that would not generate severe pressures to ease policy dramatically. Being more pessimistic about the economic situation than many other members of the Committee, he felt that the greatest hazard concerning the present stance of monetary policy was that the decline in economic activity would go too far over the next 3 to 6 months, and that it would create strong pressures for substantially easier monetary and fiscal policies, thereby undoing what had already been accomplished with considerable pain.

For the period until the next meeting, Mr. Sheehan said, his conclusion with respect to the Federal funds rate was the same as the Chairman's. Too often in the past, the System had shifted abruptly between fighting inflation and fighting recession and unemployment, and now he would prefer to see a more gradual easing. The funds rate had declined about 200 basis points since mid-July, and he would prefer that it continue to decline at about that pace. If it declined another 3/4 of a point to a little over 11 per cent by the time of the next meeting and then another 3/4 of a point in the following inter-meeting period, a gradual easing might be accomplished without precipitating a rapid decline in other market interest rates. For the longer-run M_1 target, he preferred a rate

of 6 per cent to the 5-3/4 per cent shown under alternative B; in general, he would shade the alternative B specifications for the aggregates in the direction of alternative A, but he did not feel the need to argue for that at this time.

Chairman Burns remarked that everyone knew the President's objectives for total Federal expenditures, but experience had shown that there could be a wide gap between the amount sought and the amount actually spent. With respect to the unemployment problem, the President almost certainly would ask for a contingency plan that would call for a sizable increase in public service employment in the event of a rise in the unemployment rate beyond a certain point. The particular details of the plan were under discussion at present, and he would guess that 6 per cent would be the rate that would bring the expanded program into operation.

Mr. Holland said the economy clearly was changing in important ways--that cross-currents were at work and an adjustment was underway. Although painful, the adjustment was necessary; it might have to continue over a span of years in order to restore reasonable stability of prices, and that had to be taken into account in the formulation of monetary policy. With respect to the course of economic activity, therefore, the most that one should seek was a shift to modest increases in real GNP after the

spring of 1975. Although an earlier upturn would be welcome, it was unlikely. In fact, he was not altogether confident that an upturn would occur immediately after the spring without some stimulus from policies other than monetary policy.

Mr. Holland observed that, given the long-term nature of the current problem, he would favor a policy of continued monetary and credit firmness for another month or two--in order that monetary policy's dampening effect on demands for goods and services be continued a little longer. In the present circumstances, however, holding the Federal funds rate at its current level was not consistent with maintenance of the existing degree of monetary restraint but rather would permit an undesirable further cumulation of grinding pressure of credit tightening already spreading through the financial system. Similarly, continuation of growth in the monetary aggregates--M_1, in particular--at the low pace of the last few months would not constitute a steady policy but would involve an undesirable intensification of pressures.

Consequently, Mr. Holland continued, he favored the language and specifications of alternative B, although he would prefer a longer-run target for M_1 of 5-1/2 rather than 5-3/4 per cent because he thought that the demand for money would not rebound as strongly in the autumn as suggested by the staff projections. In

his judgment, a 5-1/2 per cent rate of growth over the next two quarters would be consistent with the over-all monetary and credit conditions that he favored. Also, he would specify a short-run range of tolerance for M_1 of 3 to 5-1/2 per cent--rather than 3-1/4 to 5-1/4 per cent, as shown under alternative B--in part because specifications in terms of quarters of percentage points suggested more precision in the control of the aggregates than the System could in fact exercise. Wishing to avoid giving a signal of an overt and large change in policy, he favored the 10-1/2 to 12 per cent range for the funds rate that had been suggested by the Chairman. In the event that growth in the aggregates in the September-October period appeared to be weaker than projected and the funds rate was pressing against the lower limit of its range without producing satisfactory results, the Chairman could consult with the Committee.

In the present circumstances, Mr. Holland observed, it would not be appropriate to hold the funds rate at its current level until such time as growth in the aggregates appeared to be at one or the other extreme of their ranges. Rather, the Desk should move the funds rate down gradually to about 11 per cent by the time of the next meeting, unless the aggregates appeared to be growing at rates close to either of the specified limits. Such action would produce some desirable side-effects in terms of a little lessening of tensions in financial markets and in terms of the System's public relations.

Mr. Bucher commented that he was encouraged to learn that the Administration almost certainly would propose an expanded public employment program. However, the staff projection already incorporated an assumption of an expanded program, and the projected rate of unemployment nevertheless rose above 7 per cent in the second half of 1975.

Chairman Burns remarked that the staff projection also incorporated an assumption of Federal expenditures for fiscal 1975 of just under $300 billion on a unified budget basis. If circumstances developed that would bring the expanded public service employment program into operation, total expenditures would undoubtedly exceed $300 billion by some amount.

Continuing, Mr. Bucher said he shared the concern about developments in the debt and equity markets, particularly because of the effects of those developments on the ability of business to finance plant and equipment expenditures and thereby to improve the supply situation--which was one aspect of the inflation problem that warranted more attention. However, he would not want to see real GNP decline continuously through the second quarter of 1975, or the unemployment rate rise to more than 7 per cent in the second half of that year--outcomes the staff anticipated if the Committee adopted the alternative B specifications. He also was

dissatisfied with the projected rate of increase in prices, but he viewed the fight against inflation--which he supported--as a longer-term problem. He disagreed with the position that monetary policy had been a major cause of the inflation. In his view, the staff projections were beginning to suggest that the price--in terms of foregone output and employment--that would be paid for not having a little more patience in dealing with inflation was too high.

Mr. Bucher said he realized that nothing could be done at this point to avoid a further decline in economic activity over the next few months. He also agreed that the Committee should be gradual in its policy moves--he was a long standing believer in gradualism--and that it should not signal a major change at this point. Accordingly, he was willing to follow the course of just trying to stem any further declines in real GNP for a while. However, he would want growth in real GNP to resume sooner than the staff suggested it would under alternative B.

Mr. Bucher remarked that he had been uncomfortable with the degree of monetary tightness reached a few months ago, and he had viewed the subsequent gradual lessening of restraint as appropriate. He would like to continue on that course now. He could accept the longer-run target of 5-3/4 per cent for M_1 specified

under alternative B, but otherwise, he preferred specifications between those of alternatives A and B. Thus, he preferred an upper limit for the M_1 range over the September-October period somewhat above the 5-1/4 per cent of alternative B, and he favored a Federal funds rate range of 10 to 12 per cent or even 9-3/4 to 12 per cent. In his judgment, a decline in the funds rate below 10-1/2 per cent would not cause a major over-reaction, provided the decline was managed gradually and carefully and was allowed to occur more or less in response to market forces. The language of alternative B was acceptable.

Chairman Burns remarked that the decline in economic activity this year was not due fundamentally to monetary policy or to any other Government policies. Rather, it was a result of the corrective forces released by the inflationary boom that had been going on in this country for the past 10 years. Inflation had caused the decline in real GNP, in real income of the working man, and in purchases of big-ticket items; inflation had caused the erosion in profits, the rise in interest rates to extraordinarily high levels, the weakness in the bond markets, and the price declines in the stock exchanges. That important truth was sometimes neglected.

Mr. Mitchell commented that he agreed with the Chairman's remarks, but one also had to ask what had caused the inflation. It was the interaction between the consequences and the causes of inflation that made the problem so difficult for the Committee.

Mr. Black observed that in considering the policy issue four considerations were foremost in his mind: (1) the recent slowing of growth in M_1, which he believed would be more persistent than the staff seemed to think; (2) the shaky condition of financial markets and business and consumer uncertainty about the future; (3) the deterioration in business conditions since the Committee's last meeting; and (4) the continuance of inflation as the major problem.

Continuing, Mr. Black commented that he would not want to see a quick revival in economic activity, for the reasons that had been suggested by the Chairman. It would be preferable if activity remained close to current levels for a time, and in any case--as Mr. Holland had suggested--probably the most one could hope for was an upturn in real GNP after the spring of 1975. For the longer-run M_1 target, he favored a rate of 5-1/2 per cent, believing that 5-1/2 most likely was as high a rate as could be achieved with the degree of change in interest rates that would be tolerable. While he agreed with Mr. Francis that growth in M_1

at a 5-3/4 per cent rate throughout the remainder of the year and then at a 5-1/2 per cent rate would be desirable, he doubted that the System could achieve that sort of fine tuning.

Mr. Black said he would accept the 2-month specifications for the aggregates shown under alternative B and the funds rate range that had been suggested by the Chairman. Like Mr. Holland, he believed that the Desk should move the funds rate down gradually--perhaps even below 11 per cent, if market forces worked in that direction and growth in the aggregates did not show unexpected strength--because it would be undesirable for the slow rate of monetary growth to persist into the fourth quarter. Concerning the discount rate, he agreed with the Board's action in disapproving the reduction for the reasons that had been cited.

Mr. MacLaury remarked that the chances of stimulating a prompt revival in economic activity, even if desired, were so low that he did not consider it a genuine alternative. Most would agree, he thought, that it would be desirable to attempt to stem any further decline in activity. The slowdown in monetary growth since June could not be ignored; he was prepared to believe that it reflected some fundamental causes and that a rebound in the fourth quarter of the year was most uncertain. Thus, he agreed with Mr. Gramley's policy prescription and with his rationale for it in terms of economic prospects.

Mr. MacLaury observed that in the present situation of weakening economic activity, Committee members appeared to define a policy change in terms of the behavior of interest rates rather than growth of the monetary aggregates. Even in terms of the aggregates, moreover, members seemed to describe an adjustment in the longer-term M_1 target upward from 5-1/4 per cent as a change in policy, and yet--as Mr. Eastburn's analysis indicated--the 5-1/4 per cent rate adopted at the August meeting implied growth of 5-3/4 per cent over the whole of this year; now, a 6-1/4 per cent growth rate from the August base to March 1975 would be required in order to return M_1 to a 5-3/4 per cent growth path. He continued to favor growth of 5-3/4 per cent for this year and, consequently, would accept a longer-run target of 6-1/4 per cent. Given the recent deterioration in the economic outlook, one could make a case for a change in policy to a higher rate of monetary growth. In terms of growth rates based on quarterly average levels--which he believed was the more appropriate basis--Appendix Table IV of the blue book indicated that the 6-1/2 per cent longer-term growth rate of alternative A involved rates of 5.7 and 5.9 per cent in the fourth and first quarters, respectively, rather than the rates of 7.1 and 7.0 per cent calculated on the basis of last months quarters.

Since he favored a 6-1/4 per cent longer-run M_1 target, Mr. MacLaury said, he generally preferred specifications closer to those of alternative A than of alternative B, except for the Federal funds rate. He shared the common view that the Committee should be careful to avoid giving a false signal to the financial markets, and therefore, he would be content with the funds rate range of 10 to 12 per cent specified under alternative B. Concerning the discount rate, it was conceivable that an increase, to bring the rate closer into alignment with market rates, at some time during the 5-week interval until the next meeting might counteract any signals that the financial markets might otherwise see in a further decline in the funds rate.

Mr. Balles remarked that the kind of demand stimulus needed to bring about a prompt revival in economic activity would preclude the successful pursuit of a policy that would substantially reduce inflation from the two-digit rate now prevailing. In his view, it would be premature at this time to back down from the course of moderate monetary restraint that the Committee had been following. The clamor of voices calling for an easing in System policy--such as was heard in the recent sub-summit meeting of economists with the President--had been expected in response to the maintenance of monetary restraint. In a meeting at the San Francisco Bank 3 days

earlier--attended by Senator Cranston, Sherman Maisel, George L. Bach, and other economists and businessmen--almost everyone had called for the System to ease policy. Eventually, however, Bach pointed out that a year ago most economists were telling the System that policy had been too expansive and that monetary growth needed to be slowed down; now that the System had succeeded in doing that for a few months, the same people were calling for policy to be eased.

Mr. Balles observed that because of the cross-currents and the disequilibria that the Chairman had noted, less than the usual degree of reliance could be placed on forecasts. The staff's view of the outlook might prove to be correct, although he hoped it would not, but what had not been fully spelled out was the terrible price that would be paid if inflation was not brought under control. He was prepared to accept sluggish economic growth for 6 to 9 months, if necessary, because he believed that failing to bring inflation under control was far more costly to the foundations of our society.

Mr. Balles said he favored a longer-run M_1 target of about 5-1/2 per cent. Whether the adopted target was 5-1/2 or 5-3/4 per cent, however, it was important to raise monetary growth from the low rate of the past 3 months up to about the rates that the Committee had anticipated; unfortunately, the market would not know whether to

interpret a 4 per cent rate of growth in M_1--as was now projected for the third quarter--as a result of Committee policy or of an accident. In the weeks ahead, the Committee would have a great opportunity to lower interest rates, while holding growth in the aggregates within acceptable ranges. Accordingly, he would not be reluctant to see the Federal funds rate decline to 10 per cent, and he would be a little bolder that those who had called for moving the rate down gradually--as long as growth in the aggregates, and particularly in M_1, remained close to the 5-1/2 per cent longer-run target. He agreed with the remarks of others concerning the cumulative effects of the maintenance of the current levels of interest rates along with the slow rate of monetary growth. Altogether, he favored the short-term specifications of alternative B, including especially the 10 per cent lower limit of the range for the funds rate.

Mr. Morris remarked that he would like to urge the Board to be prepared to reduce reserve requirements this fall. In his view, the System needed to have a long-term strategy to take advantage of opportunities to lower the cost of being a member of the System. To reduce reserve requirements, two conditions had to be present: a need to supply a substantial amount of reserves, and a willingness to give the market a policy signal.

Both of those conditions were likely to be present in the fall, and the opportunity should not be lost.

Continuing, Mr. Morris observed that the most desirable course of economic activity--if policy could be fine-tuned--would be one that moved the unemployment rate up to 6 per cent and held it there for the next 2 years. The American people now would be willing to accept a 6 per cent rate as a cost of combatting inflation. More slack than that would not make much of a contribution toward achieving price stability, and it would run the risk of generating political forces in favor of efforts to reduce the level of unemployment--efforts which might then result in the more typical rapid recovery in activity. It would be better to pursue a policy of restraint that could be maintained for a while.

Mr. Morris commented that for the period through the first quarter of 1975 he would support the 5-3/4 per cent longer-run target for M_1 of alternative B, even though the staff projections suggested that it would result in an unemployment rate above 6 per cent. It was especially important, however, that growth not continue to fall short of that rate, because the recent rate of growth was unacceptably low. Thus, he would accept the alternative B range of 10 to 12 per cent for the funds rate, and would instruct the Desk to move the rate down to 11 per cent within the next 10

days and to be prepared to move it down further if it appeared that growth in the aggregates would remain slow. The market was not likely to misjudge the significance of such a decline in the funds rate in the circumstances of sluggish growth in the aggregates; any reaction in the money market was likely to be short-lived. In any case, for years the System had given too much weight to the fear of excessive market reactions to its actions. The Committee should take the actions that the members thought were desirable, and if market professionals made misjudgments, they would have to pay the price.

Mr. Clay observed that the most pressing problem continued to be the accelerating rate of inflation. The present policy of restraint had to be continued until there were some indications of progress in combatting inflation, or the fight would be lost. Such indications, when they appeared, would do a great deal to stimulate business activity and to improve conditions in the financial and stock markets. Therefore, it would be desirable for economic activity to remain close to the current level. He hoped that prompt action would be taken to stem an actual, but not a prospective, decline in activity.

Mr. Clay said he did not fully understand the reasons for the shortfall in M_1 growth in the recent period, but it might be

significant that growth in the other aggregates had been closer to expected rates. In the period immediately ahead, growth in most of the aggregates was likely to be strong, as businesses borrowed to meet liquidity needs and to speculate on inventories. Demands for funds also would be strong in the capital markets, reflecting business needs to finance plant and equipment spending and Federal agency needs. However, growth in M_1 was likely to be restrained, as individuals and businesses sought to minimize holdings of non-interest earning balances. In any case, he hoped the System would have more success in achieving its targets for growth in the monetary aggregates in coming months than it had experienced since June. For the period ahead, he favored a slight easing, with any move in that direction carried out very gradually so as to avoid interpretations that the System had given up the fight against inflation. Accordingly, he favored the specifications of alternative B, shaded very slightly toward those of alternative A.

Mr. Winn remarked that the problems of inflation were foremost among the concerns of the people. The System's goal should be to make its contribution to the maximum growth in output consistent with stable prices, and in the present circumstances, the pursuit of stable prices implied continuation of economic activity at about the present level for a period of time.

Mr. Winn observed that the behavior of the monetary aggregates and its impact on economic activity might be different now from a few years ago, because of such developments as individuals' placement of funds in marketable Treasury securities instead of savings accounts, corporations' efforts to minimize cash balances, and the tremendous growth of CD's. Perhaps something could be learned from the experience in Canada, where the economy had been able to accommodate an interest rate structure that was substantially higher than that in the United States.

Because of the uncertainty in interpreting the behavior of the aggregates, Mr. Winn said, he would not wish to emphasize any one over the others. In the longer run, he would not be unhappy if growth in the aggregates fell within the over-all ranges encompassed by the three alternatives; he would be concerned if growth rates fell outside those ranges, as had occurred in the past. His feeling about the short-run targets was the same, and he would like to think that the Committee could hold another meeting before the one scheduled for mid-October in the event that the aggregates appeared to be growing at rates outside those ranges. With respect to the funds rate, he believed that a substantial decline in a relatively short period would be widely misinterpreted and would lead to an inflationary burst that would only create more severe

problems in the future. Therefore, he would prefer to ease the rate down gradually within a range of 10-1/2 to 12-1/4 per cent while carefully monitoring the behavior of the aggregates. Growth in the aggregates should not be permitted to drag; neither should it be excessive, as it was a few years ago when the System faced a similar problem. If the money supply were to grow at a 10 per cent rate this autumn, the System's credibility would be completely lost.

Mr. Mitchell remarked that he shared Mr. Gramley's apprehension concerning the future course of economic activity. He also agreed with Mr. Wallich's view concerning the lags between changes in monetary policy and their effects; the course of activity was already determined at least for 3 months, probably for 6 months, and perhaps for as much as 9 months. To generate an upturn in residential construction, for example, the outflow of funds from the thrift institutions first had to be reversed; it would then take time before the institutions would be willing to make commitments, and still more time before builders would undertake new housing starts. In many other areas as well, a substantial amount of time would be required to revitalize activity.

Mr. Mitchell said he felt considerable uncertainty about the policy that would be appropriate in the present circumstances.

The Board's model and other systematic approaches to the issue were based on historical experience that did not include some of the elements that were causing the present problem. Nevertheless, he thought that in looking back at this period it would be desirable to be able to demonstrate that the Federal funds rate had been trending downward; he would like to be able to say that, measured by the change in the funds rate, the System had been gradually shifting its policy. He was less concerned about growth in M_1, which would fall below 6 per cent for the year except in the unlikely event that M_1 grew at an annual rate of about 8 per cent over the balance of the year. Accordingly, he would place major emphasis on a downtrend in the funds rate, and would not be disturbed if the rate moved down to, or somewhat under, 11 per cent.

Chairman Burns said he believed, on the basis of the discussion, that he could suggest a set of specifications that would reflect the Committee's intent. The specifications basically were those of alternative B, with a few modifications. Under alternative B, if it appeared that M_1 would grow in the September-October period at a rate close to or above 5-1/4 per cent--the upper limit of the short-run range of tolerance--the Desk would be required to aim for a Federal funds rate of 12 per cent.

However, in view of the low rates of monetary growth since June, it would be reasonable to raise the upper limits of the short-run ranges for the aggregates; he would suggest ranges of 3 to 6 and 5 to 7-1/2 per cent for M_1 and M_2, respectively, instead of the alternative B ranges of 3-1/4 to 5-1/4 and 5 to 7 per cent. The range for RPD's would be adjusted accordingly, to 6 to 8-1/2 per cent. For the funds rate, he believed that a range of 10-1/2 to 12 per cent would be acceptable to the majority.

Mr. Bucher remarked that raising the upper limit of the short-run ranges for the aggregates was in accordance with his own views, but he preferred a lower limit of 10 per cent for the funds rate.

Chairman Burns asked the members to indicate informally their preference between 10 and 10-1/2 per cent for the lower limit of the funds rate range.

A majority indicated a preference for 10-1/2 per cent.

Mr. Clay commented that he would be concerned if M_1 grew at a rate as high as 6 per cent over the September-October period. However, he did not believe such a rate of increase was likely, and consequently, he would not oppose the 3 to 6 per cent range.

Mr. Hayes said specification of 5-3/4 per cent for the M_1 longer-run target would represent a considerable change, and he suggested that a lower rate be considered.

The Chairman asked for an expression of preference between longer-run targets represented by growth in M_1 at rates of 5-1/2 and 5-3/4 per cent.

A majority expressed a preference for 5-3/4 per cent.

Mr. Holland observed that a number of Committee members had suggested that the funds rate be moved down gradually without waiting, as was the usual practice, to see how the aggregates were behaving in relation to the specified ranges.

Chairman Burns commented that as a rule the Manager ought not to move the rate immediately after a Committee meeting. He would say that the rate should be moved down from its present level of about 11-3/4 per cent to about 11-1/2 per cent or a shade below that by a week from now, and then to about 11-1/4 per cent by a week later, on the assumption that the aggregates appeared to be growing at rates within the specified ranges and on the further assumption that markets were not reacting in such a way as to raise questions about proceeding further. Once the 11-1/4 per cent mid-point of the range had been reached, the Desk would be guided in its operations by the behavior of the aggregates.

Chairman Burns then proposed that the Committee vote on a directive consisting of the general paragraphs as drafted by the staff and 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, the annual rates of growth for the period from August 1974 to March 1975--would be 5-3/4, 7, and 5-1/2 per cent for M_1, M_2, and the bank credit proxy, respectively. The associated ranges of tolerance for growth rates in the September-October period would be 6 to 8-1/2 per cent for RPD's, 3 to 6 per cent for M_1, and 5 to 7-1/2 per cent for M_2. The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 10-1/2 to 12 per cent.

Mr. Hayes indicated that he planned to dissent from the proposed directive.

With Mr. Hayes 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 changing little in the current quarter, following the first-half decline, and that price and wage increases are continuing large. In August industrial production, according to preliminary indications, remained near the level of recent months, while the unemployment rate edged up to 5.4 per cent. Wholesale prices of farm products rose further, on average, and announcements of increases for industrial commodities continued numerous.

In recent weeks the dollar has continued to appreciate against leading foreign currencies. U.S. bank lending to foreign borrowers diminished in July and apparently also in August, while inflows from abroad increased. The foreign trade deficit, which had narrowed in June, widened in July.

In August growth of the narrowly defined money stock was above the low pace of July but well below the 6 per cent annual rate of the first half of the year. Net inflows of time deposits other than money market CD's continued at about the July rate, but the performance of passbook savings at banks--and of total deposits at nonbank thrift institutions--remained weak. Although growth in business loans remained relatively strong in August, growth in total bank credit was moderate, and banks reduced their reliance on large-denomination CD's and nondeposit funds. Interest rates on most short-term market instruments have changed little on balance since mid-August, while rates on most types of longer-term securities have risen further. On September 4 the Federal Reserve announced the removal of the 3 per cent marginal reserve requirement on longer-term large-denomination CD's.

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, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

To implement this policy, while taking account of developments in domestic and international financial markets, 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 D.

It was agreed that the next meeting of the Committee would be held on October 15, 1974, at 9:30 a.m.

Thereupon the meeting adjourned.

Arthur L. Broida
Secretary

ATTACHMENT A

September 10, 1974

Drafts of Domestic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on September 10-11, 1974

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services is changing little in the current quarter, following the first-half decline, and that price and wage increases are continuing large. In August industrial production, according to preliminary indications, remained near the level of recent months, while the unemployment rate edged up to 5.4 per cent. Wholesale prices of farm products rose further, on average, and announcements of increases for industrial commodities continued numerous.

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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, supporting a resumption of real economic growth, and achieving equilibrium in the country's balance of payments.

OPERATIONAL PARAGRAPH

Alternative A

To implement this policy, while taking account of developments in domestic and international financial markets, the Committee seeks to achieve bank reserve and money market conditions consistent with a higher rate of growth in monetary aggregates than has prevailed over recent months.

Alternative B

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

ATTACHMENT B

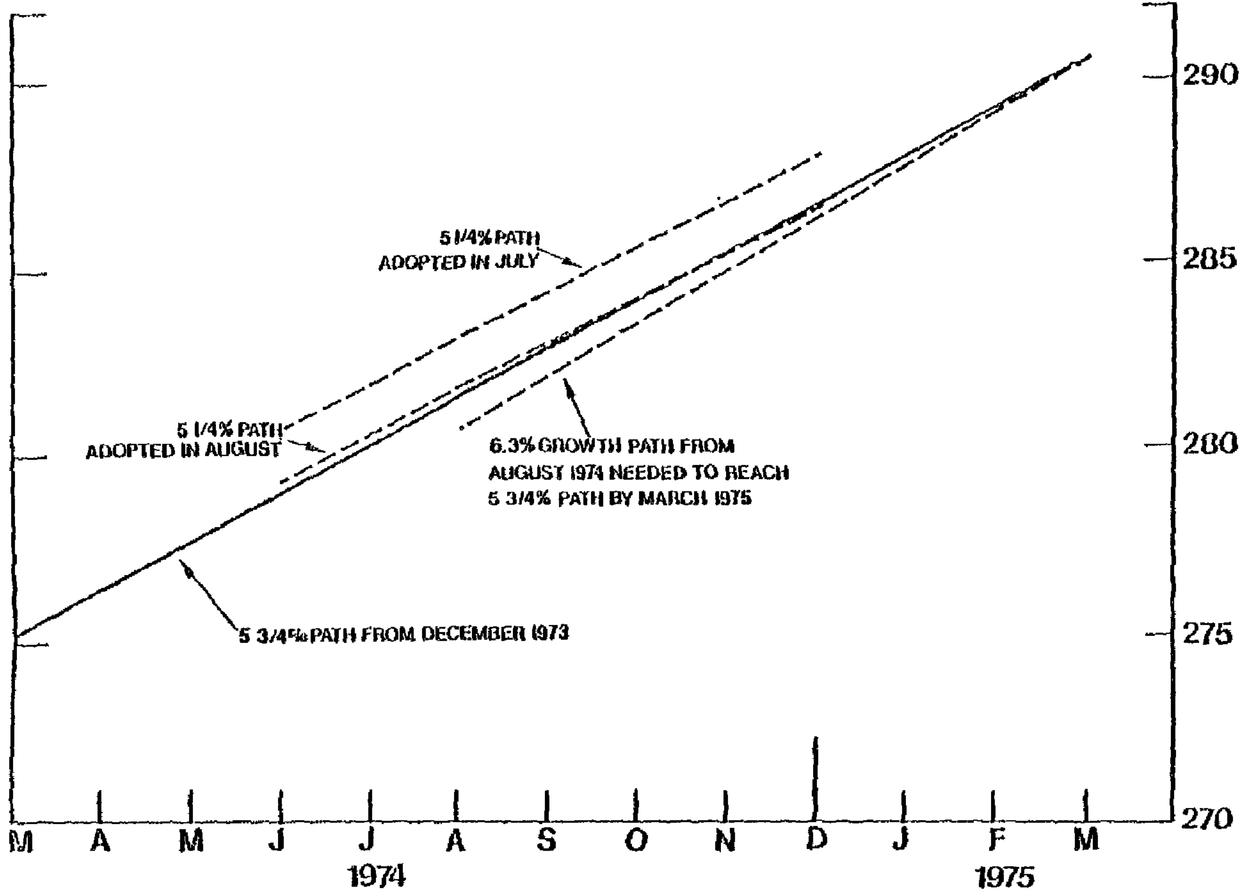
Communique Issued by Central Bank Governors of the Group of Ten and Switzerland

At their regular meeting in Basle on 9th September, the Central Bank Governors from the countries of the Group of Ten and Switzerland discussed the working of the international banking system. They took stock of the existing mechanisms for supervision and regulation and noted recent improvements made in these fields in a number of major countries.

They agreed to intensify the exchange of relevant information between Central banks on the activities of banks operating in international markets and, where appropriate, to tighten further the regulations governing foreign exchange positions.

The Governors also had an exchange of views on the problem of the lender of last resort in the Euromarkets. They recognized that it would not be practical to lay down in advance detailed rules and procedures for the provision of temporary liquidity. But they were satisfied that to that end means are available and will be used if and when necessary.

MONEY SUPPLY TARGET PATHS



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ATTACHMENT C

ATTACHMENT D

September 10, 1974

Points for FOMC guidance to Manager in Implementation of directive		Specifications (As agreed, 9/10/74)
A. Longer-run targets (SAAR): (September plus fourth and first quarters, combined)	M_1	5-3/4%
	M_2	7%
	Proxy	5-1/2%
B. Short-run operating constraints:		
1. Range of tolerance for RPD growth rate (September-October average):		6 to 8-1/2%
2. Ranges of tolerance for monetary aggregates (September-October average):	M_1	3 to 6%
	M_2	5 to 7-1/2%
3. Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):		10-1/2 to 12%
4. Federal funds rate to be moved in an orderly way within range of toleration.		
5. Other considerations: account to be taken of developments in domestic and international financial markets.		

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.