

MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Wednesday, February 19, 1975, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Black
Mr. Bucher
Mr. Clay
Mr. Coldwell
Mr. Holland^{1/}
Mr. Kimbrel
Mr. Mitchell
Mr. Sheehan^{2/}
Mr. Wallich
Mr. Winn

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

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

Mr. Broida, Secretary
Mr. O'Connell, General Counsel
Mr. Partee, Senior Economist
Mr. Coyne, Assistant to the Board of
Governors

^{1/} Entered meeting at point indicated.

^{2/} Left meeting at point indicated.

2/19/75

-2-

Chairman Burns said he regretted to report that Mr. Coombs had submitted his resignation as Special Manager for Foreign Currency Operations, effective immediately. Mr. Coombs' services had been invaluable, and his resignation represented a serious loss to the Committee and the Federal Reserve System. It was necessary, of course, to adapt to the situation created by the resignation, and with Mr. Hayes' cooperation he had worked out a proposed rearrangement of functions in the Managerial area that he would like to offer for the members' consideration.

The Chairman noted that his proposal involved the following elements: the position of Special Manager would be eliminated; Mr. Holmes, while retaining the title "Manager of the System Open Market Account," would be given over-all responsibility for foreign as well as domestic operations; Mr. Sternlight would continue to serve as deputy to Mr. Holmes in the domestic area, with his title modified to "Deputy Manager for Domestic Operations;" and Mr. Scott E. Pardee would be named deputy to Mr. Holmes in the foreign currency area, with the title "Deputy Manager for Foreign Operations." After today, it would be expected that Mr. Sternlight would customarily report to the Committee on domestic open market operations and that Mr. Holmes would report on foreign operations. With respect to the monthly Basle meetings, it would be expected that

2/19/75

-3-

Mr. Pardee would attend regularly and Mr. Holmes with some frequency.

Chairman Burns then asked Mr. Hayes whether he cared to comment on the proposal.

Mr. Hayes said he might simply express his view that the arrangements proposed represented an excellent solution to an unfortunate problem.

Others concurred in Mr. Hayes' observation. Mr. Wallich added that the proposal had the advantage of underscoring the close relationship between open market operations in domestic securities and in foreign currencies and the need for coordination of policies in the two areas.

After some further discussion, the Chairman asked the Secretary to list the formal actions needed to implement the proposal.

Mr. Broida remarked that if the Committee approved the proposal it presumably would want to take the following actions: (1) acceptance of Mr. Coombs' resignation as Special Manager for Foreign Currency Operations; (2) amendments to Section 5 of its Rules of Organization, to provide for the elimination of the position of Special Manager, modification of the titles of the Deputy Managers, and the deletion of words indicating that the Committee "may also

select" deputy managers, which had been included at a time when it was believed that the Committee would not necessarily fill the deputy positions; (3) conforming amendments to other instruments--specifically, subsections 272.3(d) and (e) of the Rules of Procedure, and paragraph 2(C) of the Foreign Currency Directive--to eliminate references to the Special Manager; and (4) selection of Messrs. Holmes, Sternlight, and Pardee to fill the positions of Manager of the System Open Market Account, Deputy Manager for Domestic Operations, and Deputy Manager for Foreign Operations, respectively.

In connection with the final item in the list, Mr. Broida noted that under the Committee's Rules the selections would be on the understanding that the persons selected were satisfactory to the Federal Reserve Bank of New York. He added that such selections were usually made at the Committee's organization meeting in March, but that, in the opinion of the Committee's General Counsel, if they were made today no further action would be required at next month's organization meeting.

By unanimous vote, the resignation of Charles A. Coombs as Special Manager for Foreign Currency Operations was accepted, effective immediately.

By unanimous vote, Section 5 of the Rules of Organization was amended to read as follows, effective immediately:

Manager and Deputies. The Committee selects a Manager of the System Open Market Account, a Deputy Manager for Domestic Operations, and a Deputy Manager for Foreign Operations. All of the foregoing shall be satisfactory to the Federal Reserve Bank selected by the Committee to execute open market transactions for such Account, and all shall serve at the pleasure of the Committee. The Manager or his Deputies keep the Committee informed on market conditions and on transactions they have made and render such reports as the Committee may specify.

By unanimous vote, subsections (d) and (e) of Section 272.3 of the Rules of Procedure were amended to read as follows, effective immediately:

Section 272.3--Meetings

* * * *

(d) Attendance at meetings.--Attendance at Committee meetings is restricted to members and alternate members of the Committee, the Presidents of Federal Reserve Banks who are not at the time members or alternates, staff officers of the Committee, the Manager and Deputy Managers, and such other advisers as the Committee may invite from time to time.

(e) Meeting agendas.--The Secretary, in consultation with the Chairman, prepares an agenda of matters to be discussed at each meeting and the Secretary transmits the agenda to the members of the Committee within a reasonable time in advance of such meeting. In general, the agendas include approval of minutes of actions and acceptance of memoranda of discussion for previous meetings; reports by the Manager or Deputy Managers on open market operations since the previous meeting, and ratification by the Committee of such operations; reports by Economists on, and Committee discussion of, the economic and financial situation and outlook; Committee discussion of monetary policy and action with respect thereto; and such other matters as may be considered necessary.

By unanimous vote, paragraph 2(C) of the Foreign Currency Directive was amended to read as follows, effective immediately:

To aid in avoiding disorderly conditions in exchange markets. Special factors that might make for exchange market instabilities include (1) responses to short-run increases in international political tension, (2) differences in phasing of international economic activity that give rise to unusually large interest rate differentials between major markets, and (3) market rumors of a character likely to stimulate speculative transactions. Whenever exchange market instability threatens to produce disorderly conditions, System transactions may be undertaken if the Manager reaches a judgment that they may help to reestablish supply and demand balance at a level more consistent with the prevailing flow of underlying payments. In such cases, the Manager shall consult as soon as practicable with the Committee or, in an emergency, with the members of the Subcommittee designated for that purpose in paragraph 6 of the Authorization for Foreign Currency Operations.

By unanimous vote, Alan R. Holmes, Peter D. Sternlight, and Scott E. Pardee were selected to serve at the pleasure of the Committee in the capacities of Manager of the System Open Market Account, Deputy Manager for Domestic Operations, and Deputy Manager for Foreign Operations, respectively, on the understanding that their selection was subject to their being satisfactory to the Federal Reserve Bank of New York.

Secretary's note: Advice was subsequently received that the selections indicated above were satisfactory to the Federal Reserve Bank of New York.

The Committee reviewed a draft of a press release, announcing Mr. Coombs' resignation and the appointments just agreed upon,

2/19/75

-7-

which was planned for issuance tomorrow. In the course of this discussion, it was noted that Mr. Coombs would remain in his position as Senior Vice President of the Federal Reserve Bank of New York until June 1, 1975, but that during his remaining service with that Bank he would not be connected with the Foreign Function or have access to confidential information regarding current policies of, or operations on behalf of, the Federal Open Market Committee.

Chairman Burns then said there were a few other matters on which he would like to comment briefly. The Congress, which had been actively engaged in discussing a large variety of matters, had the Federal Reserve very much on its mind. Some legislation involving the System had been proposed which, in his judgment, could be highly injurious to the country. The Federal Reserve would do what it could to oppose such legislation, and while he could not say whether its efforts were likely to be successful, he continued to hope that good sense would prevail.

In view of the prominence being given to the Federal Reserve in public utterances, the Chairman continued, it was particularly important that whatever differences might exist within the System be debated around the table and not aired in public. To his mind, no good purpose would be served if any

2/19/75

-8-

member of the System family were to carry such differences as he might have with his colleagues into the public arena. It was not to be expected that every Board member and Reserve Bank President would find every decision taken by the Board or the Committee entirely congenial, and every member of the System family could expect from time to time to find himself unable to convince his colleagues on some issue. For one in that position to try to win over his colleagues by carrying his case to the public--and thus adding to the political pressures on the Federal Reserve--could be particularly injurious at the present time.

Chairman Burns added that he had followed the practice of consulting with his colleagues about the contents of any planned speech or Congressional testimony, even when the statement was to be a personal one. Practically everyone present today had done the same. He thought it was desirable for all to continue that practice, particularly in a period as sensitive as the present. Perhaps it was unnecessary for him to convey that word of counsel; he had offered it with the thought that it might be helpful at this time.

The Chairman then observed that he would like to have the advice of the Committee on a particular matter. He would

2/19/75

-9-

be testifying before the House Banking Committee this evening, and before the Senate Banking Committee on February 25. The hearings in the Senate would be concerned with the concurrent resolution that had been drafted by Senators Proxmire and Humphrey, with which the members were no doubt familiar. He intended to argue that the resolution was entirely unnecessary, in the sense that it instructed the Federal Reserve to do what it already was doing. That is, the Federal Reserve clearly wanted a substantially more rapid rate of growth in the monetary aggregates than had been recorded in the past few months; it had set its targets in that manner, and had no quarrel with any Congressional objective on that score. He might be able to make the point a little more clearly if he quoted from some recent directives, including that issued at the January meeting which had not yet been published. He might note, for example, that the December directive called for "somewhat more rapid growth in the monetary aggregates than had occurred in recent months," but that the qualifier "somewhat" had been dropped in January. His question was whether the Committee thought the citation of such directive language would be desirable.

Mr. Holland entered the meeting at this point.

Mr. Mayo said he would see no problems in the Chairman's citing such directive language. He hoped, however, that the Chairman would not be pressed to provide information on the underlying specifications before they were scheduled for release.

Chairman Burns remarked that he planned to resist any such pressure. It was possible, of course, that circumstances might arise in the hearings under which he found that a constructive purpose would be served by indicating what the numerical targets were, at least in approximate terms. While he did not expect that to happen, if it did he hoped that the members would understand the special circumstances that had influenced him.

Mr. Eastburn commented that the course the Chairman had suggested struck him as a wise one. In his judgment, the broad question of the Committee's practices with respect to disclosing information was going to become an increasingly important issue for the Congress and the public generally. He thought it would be desirable for the Committee to reconsider its current practices at an early date.

The Chairman observed in that connection that the charge of excessive secrecy on the part of the Open Market Committee was likely to be raised in the hearings before the House Banking Committee this evening. If it was, he might indicate that he intended

to recommend to the FOMC that it reduce substantially the present 90-day lag in releasing its policy records. The question of the appropriate length of the lag had been raised from time to time by Committee members, and after a new analysis of the problem the staff had reached the conclusion that the lag could be shortened significantly without militating against any legitimate purpose of the Committee. He definitely shared that view. A staff memorandum on the subject would be distributed in time for consideration by the Committee at its next meeting. In any comments he might make at the hearings this evening, he would, of course, not prejudge the Committee's decision.

Mr. Bucher remarked that, under present circumstances, he would have no objection to the Chairman's quoting the language of the January directive in full, or to his talking about the underlying specifications. And he would strongly support the proposal to reduce the length of the lag for the policy records.

Mr. Wallich said he could see some merit in the Chairman's disclosing the Committee's longer-run targets if pressure for such disclosure arose at the hearings. The particular longer-run targets the Committee had adopted at recent meetings were likely to win the support not only of the Congress but also of many economists.

Mr. MacLaury concurred in Mr. Wallich's observation. He added that it was better for the Committee to be judged in terms of its failure to achieve its longer-run targets for reasons that, to his mind, were understandable, than to be mistakenly thought to be pursuing the wrong targets.

Mr. Mitchell remarked that, while he did not feel strongly about the matter, he wondered whether it was desirable for the Chairman to cite the January directive language. To indicate that the Committee had sought "more rapid growth" than had recently occurred was not very revealing, since the phrase "more rapid" could cover a wide range of growth rates. As to Mr. MacLaury's point, he might note that staff documents indicated that the Committee had failed to achieve its targets for the aggregates because of the constraints it had placed on movements in the Federal funds rate. While he did not necessarily agree with everything the staff said, he thought the whole area was a treacherous one.

Mr. Mayo remarked that he had had such considerations in mind when he questioned the advisability of disclosing the specifications.

Mr. Morris commented that such disclosure, in his judgment, would impose a useful discipline on the Committee.

Mr. Holland expressed the view that proposals to increase the amount of information provided in the policy records were in conflict with proposals to reduce the lag with which the records were released. While the Committee might decide to respond favorably to either or both types of proposals, he would be more comfortable with the release of specifications on a 90-day lag than on a shorter lag.

Mr. MacLaury observed that the key question in his mind related to the particular specifications to be released. It seemed to him that the most sensitive specification might be the short-run constraint on the funds rate. On the other hand, he saw no problem with releasing the Committee's longer-run targets with a lag significantly shorter than 90 days.

Chairman Burns remarked that in commenting on what he might say at the hearings he had not meant to raise the issue of whether the policy records should contain more information than they did at present; that issue required separate deliberation and decision by the Committee. He was grateful for the guidance he had received. He was particularly pleased that there had been no substantial objection to his suggestion that he might refer to the language of the January directive, since he thought such a reference could help him

clarify the recent direction of the Committee's thinking. He might repeat that, while he did not now plan to disclose the Committee's longer-run targets at the hearings, he might find it advantageous to do so under certain circumstances.

The Chairman then said he wanted to make one further observation, relating to the use of the term "non-voting member" in referring to Reserve Bank Presidents who were not currently members of the Committee. Technically speaking, there was no such thing as a "non-voting member"; the Committee had 12 members, all of whom voted, and those to whom the term was applied were correctly described as "non-members." There was no misunderstanding when the term was used in Committee meetings, and he saw no reason for discontinuing its use internally since it was a convenient expression. However, there had been some little difficulty recently because of misunderstandings that had arisen in the Congress. Accordingly, he thought that it should be avoided in public utterances.

A number of other subjects of common interest to Board members and Reserve Bank Presidents were then discussed, including the extent to which it was appropriate for Reserve Bank Presidents to communicate certain types of information to the directors of their Banks, and the procedures that had been followed in connection with a recent discount rate action.

The following then entered the meeting:

Mr. Altmann, Deputy Secretary
Mr. Bernard, Assistant Secretary
Mr. Guy, Deputy General Counsel
Mr. Axilrod, Economist (Domestic Finance)
Mr. Solomon, Economist (International Finance)
Messrs. Brandt, Bryant, Davis, Doll, Hocter, Parthemos, and Reynolds, Associate Economists

Mr. Holmes, Manager, System Open Market Account
Mr. Pardee, Deputy Manager for Foreign Operations

Mr. Keir, Adviser, Division of Research and Statistics, Board of Governors
Mrs. Farar, Economist, Division of Research and Statistics, Board of Governors
Mrs. Ferrell, Open Market Secretariat Assistant, Board of Governors

Messrs. Eisenmenger, Boehne, Scheld, and Jordan, Senior Vice Presidents, Federal Reserve Banks of Boston, Philadelphia, Chicago, and St. Louis, respectively
Mr. Green, Vice President, Federal Reserve Bank of Dallas
Mr. Duprey, Senior Economist, Federal Reserve Bank of Minneapolis
Mr. Keran, Director of Research, Federal Reserve Bank of San Francisco
Mr. Ozog, Manager, Acceptances and Securities Department, Federal Reserve Bank of New York

By unanimous vote, the action of members of the Federal Open Market Committee on January 30, 1975, amending a provision of paragraph 2 of the authorization for domestic open market operations by striking the word "if" in the clause "or, if the New York Bank is closed," and inserting in its place the words "under special circumstances, such as when," was ratified.

With this amendment, paragraph 2 read as follows:

The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, or, under special circumstances, such as when the New York Reserve Bank is closed, any other Federal Reserve Bank, to purchase directly from the Treasury for its own account (with discretion, in cases where it seems desirable, to issue participations to one or more Federal Reserve Banks) such amounts of special short-term certificates of indebtedness as may be necessary from time to time for the temporary accommodation of the Treasury; provided that the rate charged on such certificates shall be a rate of $1/4$ of 1 per cent below the discount rate of the Federal Reserve Bank of New York at the time of such purchases, and provided further that the total amount of such certificates held at any one time by the Federal Reserve Banks shall not exceed \$1 billion.

Mr. Broida observed that, as indicated in his memorandum dated February 18, 1975,^{1/} it would be desirable for the Committee to make a conforming amendment in Section 270.4(d) of its Regulation Relating to Open Market Operations of Federal Reserve Banks, which also contained a provision regarding purchases of certificates directly from the Treasury. He added that the Committee's General Counsel concurred in the view that it would be appropriate to make the conforming change in the Regulation effective as of January 30, 1975, since the Committee's intent had been made clear by the action of the members with respect to the Authorization on that date.

By unanimous vote, Section 270.4(d) of the Regulation Relating to Open Market Operations of Federal Reserve Banks was amended, effective January 30, 1975, by striking the word "if" in the clause "or, if that Bank is closed," and inserting in its place the words "under special circumstances, such as when."

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

With this amendment, Section 270.4(d) read as follows:

In accordance with such limitations, terms, and conditions as are prescribed by law and in authorizations and directives issued by the Committee, the Reserve Bank selected by the Committee (or, under special circumstances, such as when that Bank is closed, any other Federal Reserve Bank) is authorized and directed, for its own account or the System Open Market Account, to purchase directly from the United States such amounts of Government securities as may be necessary from time to time for the temporary accommodation of the Treasury Department.

By unanimous vote, the action of members of the Federal Open Market Committee on February 18, 1975, incorporating a fee schedule as subsection 271.4(f) in the Committee's amended Rules Regarding the Availability of Information, was ratified.

The subsection read as follows:

Fee Schedule.--A person requesting access to or copies of particular records shall pay the costs of searching and copying such records at the rate of \$10 per hour for searching and 10 cents per standard page for copying. With respect to information obtainable only by processing through a computer or other information systems program, a person requesting such information shall pay a fee not to exceed the direct and reasonable cost of retrieval and production of the information requested. Detailed schedules of such charges are available upon request from the Secretary of the Committee. Documents may be furnished without charge or at a reduced charge where the Secretary of the Committee or such person as he may designate determines that waiver or reduction of the fee is in the public interest because furnishing the information can be considered as primarily benefiting the general public, or where total charges are less than \$2.

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on January 20-21, 1975, were approved.

2/19/75

-18-

The memorandum of discussion
for the meeting of the Federal Open
Market Committee held on January 20-21,
1975, was accepted.

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 January 21 through February 12, 1975, and a supplemental report covering the period February 13 through 18, 1975. Copies of these reports have been placed in the files of the Committee.

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

For several months we have been reporting to you on the progressive decline of the dollar in the exchanges and the many reasons, mainly psychological, for that decline. As I noted last time, by mid-January the Federal Reserve, the German Federal Bank, and the Swiss National Bank were intervening in modest amounts to cushion the decline on a day-to-day basis. Nevertheless, in the speculative atmosphere which had developed, such a purely passive approach had serious drawbacks.

More specifically, the German Federal Bank, on its own interpretation of the EC intervention plan, was intervening rather mechanically to limit the slippage of the dollar to 1 per cent per day in Frankfurt but showed reluctance for us to follow up its operations, suggesting that we intervene in considerably smaller amounts and at lower dollar rates than it had dealt earlier the same day. Consequently, we had to stand aside and watch dollar rates slide consistently lower

in New York trading, even on days when several major European central banks had intervened to support the dollar. Dealers here and abroad sensed the difference and exploited it.

The Swiss intervention had shown reasonably good results until the closure of yet another Sindona-affiliated institution left a major Swiss bank with a huge short position in francs. As soon as that bank began to cover itself in the market, a broader speculative demand for francs erupted. The National Bank at first met the surge of demand head on, but after taking in more than \$300 million in 3 days, it retired to the sidelines and asked us to suspend Swiss franc operations in New York as well. The franc rate simply rose higher, adding to the general pressure on the dollar.

By late January, as compared with last September's peak levels, the dollar had fallen nearly 22 per cent against the Swiss franc and 15 per cent against the German mark and had been pulled down almost as much against most other continental European currencies. Moreover, in the generalized market demoralization that had developed, the dollar was beginning to drop off against currencies which themselves had been weak, such as the pound sterling, the Japanese yen, and even the Italian lira. By that time, also, officials on both sides of the Atlantic were openly expressing concern over the unrealistically low levels to which the dollar had been driven.

Against this background, Chairman Burns initiated discussions with the German Federal Bank and the Swiss National Bank to explore a more forceful and better coordinated approach to the market. Even the first round of telephone calls was fruitful, as the German Federal Bank agreed to joint operations to resist further erosion of dollar rates. Consequently, in the last week of January we were able to intervene more firmly, with the result that the dollar stabilized and actually improved somewhat against the mark.

The agreements reached in London on February 1^{1/} set the basis for a much more effective approach to the market. In fact, on Monday, February 3, the German

^{1/} A report on the London meeting was distributed to the Committee on February 10, 1975. A copy is appended to this memorandum as Attachment A.

Federal Bank and the Swiss National Bank countered a further decline of the dollar through coordinated dollar purchases, and the Federal Reserve followed up in New York with sizable offerings of marks and Swiss francs as well as Belgian francs and Dutch guilders. The operation, and its confirmation by the respective central banks, prompted a solid recovery of the dollar, which rose by more than 3 per cent in 2 days. I might note that the Belgian, Dutch, French, British, and Italian central banks joined in as buyers of dollars at the time.

Even so, just about everything that has happened since then has re-fortified the bearish sentiment which drove the dollar down in the first place--particularly the further decline in U.S. interest rates and the discomforting unemployment and industrial production figures for the United States. The sharp debate over fiscal and energy policies here, and the gloomy forecasts which have been deployed in that debate, have also had a chilling effect on the markets, as have the persistent fears over renewed hostilities in the Middle East. Many of these concerns are clearly exaggerated in the market and any good news, such as the latest drop in U.S. wholesale prices, is ignored.

Our more forceful approach to the market continues, but we have had to revert to a holding action, and the dollar is back near its lows. This difficult period may persist for a while, but once any one of these psychological roadblocks is lifted, the dollar could recover sharply. At the beginning of that recovery, at least, we should be prepared to help the dollar along with sustaining intervention. The amounts need not be large.

Our intervention totals have mounted. But, even at current exchange rates, we are not far from our break-even points on our drawings, so that the risk of loss remains small.

Mr. Bucher observed that of the swap drawings made since September, about \$700 million were now outstanding--an amount that he regarded as rather large. Cumulative intervention to that

2/19/75

-21-

extent suggested that an argument could now be made that System intervention in the market, rather than merely smoothing out daily fluctuations and avoiding disorderly conditions, represented an effort to resist a downward trend in the value of the dollar on the assumption that the System knew better than the market what the dollar's value ought to be and what it would eventually prove to be. Noting Mr. Pardee's statement that by late January officials on both sides of the Atlantic had expressed concern that the value of the dollar had fallen to an unrealistically low level, he nevertheless was led by yesterday's staff briefing of the Board to question whether some basic forces were working to depress the dollar. Given the uncertainty about the course of exchange rates, he wondered if some difficulties might arise in paying off the outstanding drawings within 6 months or a year and if consideration should be given to placing some limitation--such as one-half of a billion dollars or a billion dollars--on the extent of additional swap drawings for the purpose of resisting further downward pressure on the dollar.

In response, Mr. Pardee commented that at present there were differences of opinion concerning such fundamental forces affecting exchange rates as the likely course of economic activity in this country and in the major European countries. The immediate

2/19/75

-22-

problem in the market, however, had less to do with fundamentals than with the state of psychology; people thought the dollar was weak and would become weaker. Market participants had an exaggerated view about how far interest rates were likely to decline in this country and had not noted that interest rates had fallen elsewhere. In Germany, interest rates currently were lower than those in the United States, and yet the mark continued to rise. In these circumstances, intervention was appropriate to cushion further declines in the dollar that might develop and to maintain orderly conditions.

In his judgment, Mr. Pardee said, the fundamentals were such that the dollar should be strengthening in the exchange markets. He believed that a turnaround would occur, but when it came depended on a change in market psychology. He preferred that the Committee not impose a ceiling on the amount of intervention; if it did, System operations would be perceived as weak, and the market would exploit the situation. As he had noted in his statement, current exchange rates were not far from the breakeven points on existing drawings, and he hoped that recovery in the dollar would enable the System to unwind the swap debts without losses.

Chairman Burns remarked that the System's exposure with respect to losses was half the amount that might be suggested by the total of swap drawings, because the System had agreements with other central banks to share profits and losses on a 50-50 basis.

Mr. Holland observed that he disagreed with Mr. Pardee's statement that the System should be prepared to sustain intervention at the beginning of a recovery in the dollar in order to help it along. As soon as such a recovery began, he would be advocating use of the opportunity to purchase foreign currencies in order to reduce outstanding drawings on the swap lines.

Mr. Pardee said he wished to purchase currencies and repay debt as soon as possible. At the outset of a rally, however, it might be useful to offer currencies to consolidate the improvement in dollar rates. As soon as the rally became self-sustaining, and the markets were settled for a day or two, he would plan to start buying back the foreign currencies.

Mr. Hayes commented that the London agreement to intervene in the market more vigorously was constructive. Even though the concerted intervention had not entirely succeeded as yet, it probably would be instrumental in turning the market around, and he would like to see it continue.

2/19/75

-24-

Mr. Mitchell remarked that he had got the impression from Mr. Pardee's report that the operation had not been so productive. It was begun with the expectation that small purchases would be highly successful. Purchases had been small, but the market situation did not appear to have been changed.

Chairman Burns asked whether he was correct in his impression that the dollar was stronger now than at the time of the London meeting.

Mr. Pardee replied that there had been some improvement and that the market was more orderly. Market participants recognized that central banks would intervene in the event of declines in the dollar, and consequently, the dollar had not declined progressively, day by day.

Mr. Bryant said the dollar was a bit stronger than at the low in the week preceding the London meeting on February 1, but it was about unchanged from its position at the end of that week. Some of the gains that had occurred in the first few days of concerted intervention had eroded since February 5.

Mr. Mitchell observed that he thought the System's purpose had been accomplished if in fact the market was more orderly. Operations toward that end were more consistent with the Committee's criteria for intervention than were massive purchases to strengthen the dollar.

2/19/75

-25-

Mr. Wallich remarked that he had never argued in favor of intervention for the purpose of pushing up rates for the dollar, but market conditions could arise in which it was important for a country to demonstrate that it was concerned about its currency. The United States had been suspected of taking no interest; now, it had shown an interest, and that had contributed to orderly markets. For the time being, interest rate developments were the dominant influence in the market, and they were adverse to the dollar. Eventually, however, the dollar was likely to strengthen because the U.S. balance of payments was not bad compared to that of most other countries--although, unfortunately, that was not the case with respect to Germany. One difficulty in the present situation arose from the fact that the System intervened with German marks--because it was very difficult to accomplish its objectives any other way--and yet the underlying position of the mark was strong. At the same time, currencies of countries whose positions were poorer than that of the United States--in terms of international payments and price trends--nevertheless had been rising against the dollar.

Mr. Black asked Mr. Pardee whether, in his judgment, System actions to ease money market conditions further at this time, possibly followed by another cut in the discount rate, would have a significant impact on the exchange rate for the dollar against other leading currencies.

2/19/75

-26-

Mr. Pardee replied that further actions now would tend to confirm market expectations of continuing ease, but he was not sure if expectations of a further discount rate cut had already been fully reflected in exchange rates.

Chairman Burns commented that if the Board wished to reduce the discount rate again, it would be best if the reduction followed rather than led actions abroad. Toward that end, the Board might consult with other central banks. There was a reasonable chance that such efforts would be met with success, and that would minimize the negative effects on the exchange rate for the dollar. Some consultations of that sort had occurred regarding recent reductions in the discount rate.

Mr. Black remarked that he would strongly urge that such efforts be made.

Mr. Bucher noted that the Foreign Currency Directive contained the following statement: "Whenever supply or demand persists in influencing exchange rates in one direction, System transactions should be modified or curtailed unless upon review and reassessment of the situation the Committee directs otherwise." It would be helpful to him and, he believed, to other members of the Committee if at the time of the next meeting Mr. Pardee was prepared to make a recommendation in light of that statement in the directive.

2/19/75

-27-

Mr. Balles asked whether a decline in the exchange rate for the dollar at this time would not benefit the U.S. economy by stimulating exports.

In response, Mr. Pardee observed that government officials in Germany, Switzerland, and elsewhere had become concerned about the decline in the dollar because of the threat that it posed to their own exports and because of the implications for economic activity in their countries. Those concerns suggested that there was a danger in looking to a decline in the exchange rate as a source of economic stimulation, because other countries also could adopt that point of view.

Chairman Burns commented that issues other than the impact on exports needed to be kept in mind in considering the behavior of the value of the dollar. The United States still had a serious problem of inflation, and the depreciation of 6 per cent that had occurred in the average exchange rate for the dollar against leading foreign currencies since September would exert upward pressure on the U.S. price level. Moreover, every depreciation in the value of the dollar was a blow to the nation's prestige, which added to difficulties in the conduct of foreign policy. How much weight should be given to such considerations was difficult to say, but they could not be ignored.

Mr. Hayes remarked that he agreed with the Chairman's comments. It should also be borne in mind that a continuing decline in the value of the dollar--while it would stimulate exports--could foster a conviction that the dollar would become a progressively less valuable currency, which in turn could lead to large outflows of capital from the United States.

Chairman Burns added that members of OPEC received payment for their oil exports primarily in dollars, and every decline in the value of the dollar against leading foreign currencies might provide incentives for them to shift out of dollars or to raise the price of oil still further.

Mr. Francis asked whether the concern about the stimulative effect on U.S. exports that would result from declines in the value of the dollar had been expressed mainly by Germany and other countries whose trade balances were strong.

Mr. Pardee replied in the negative, noting that the French, the Italians, and the British had welcomed the new approach to intervention in the exchange markets.

In response to a question by the Chairman, Mr. Wallich observed that participants at the latest Basle meeting of central bankers^{1/}--who were inclined to suspect the United States of

^{1/} A report by Mr. Wallich on the February Governors' meeting in Basle was distributed during this meeting. A copy is appended to this memorandum as Attachment B.

following a policy of benign neglect with respect to the value of the dollar--in general had welcomed the new approach to intervention as a sign of U.S. concern. There was disagreement over whether the market now was in such a state of uncertainty that a small push in one direction would produce a substantial effect. In his own view, a great deal depended on the course of interest rates, on the Federal budget in this country, and on the psychological factors that Mr. Pardee had mentioned. Such factors had not yet developed in a way that was favorable to an upturn in the value of the dollar. He would not fight the forces currently tending to depress the dollar, because they appeared to him to be of a more fundamental nature in a cyclical sense--lasting, perhaps, for a couple of quarters.

By unanimous vote, the System open market transactions in foreign currencies during the period January 21 through February 18, 1975, were approved, ratified, and confirmed.

Mr. Pardee reported that one System drawing of \$18.7 million on the German Federal Bank and one of \$7.4 million on the Swiss National Bank would mature for the first time on March 19, 1975. He recommended that those drawings be renewed for further periods of 3 months, if necessary, when they matured.

Renewal for further periods of 3 months of System drawings on the German Federal Bank and the Swiss National Bank, maturing on March 19, 1975, was noted without objection.

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

Mr. Partee made the following statement:

Economic activity dropped very sharply again in January, making the contraction over the past 3 months the largest for any similar period since before World War II. Thus, since October, industrial production has declined by 9 per cent and nonfarm employment by 1-1/2 million persons. Retail sales have remained generally sluggish over this period, aside from the recent spurt in new car deliveries in response to temporary cash rebate programs of the manufacturers. And residential construction activity has continued on a sharply declining trend, reflecting the very low levels to which housing starts have fallen. But the most dynamic elements in the recent picture probably have come from capital spending, which appears to be moving downward at an accelerated pace, and from the large and widespread shift from inventory accumulation to liquidation that is clearly under way.

Because of these developments, the staff economic projections for this and the next quarter again have been revised downward, and by a substantial amount. We are now expecting a marked further decline in real business fixed investment, reflecting the pervasive weakness in current output, new orders, and the square footage of construction contract awards. And we believe that inventory investment will turn negative this quarter, reaching a \$15 billion rate of liquidation in the spring, as businesses have growing success in cutting stocks of both materials and finished goods. Since consumption is unlikely to be strengthening in the economic environment described, and fiscal stimulants will not yet have had time to take hold, the result is projected

to be a large further drop in real GNP. Accordingly, we would now expect the unemployment rate to reach 9-1/2 per cent by this summer.

After midyear, however, we still believe that an economic upturn is probable. It is conceivable that this might not occur, since the circular process of cuts in output, jobs, income, consumption, and investment could gather such strength that confidence is destroyed and a wave of business bankruptcy materializes. But it seems more likely that an upturn will come; first, because incomes are dropping much less rapidly than output, due to unemployment insurance, welfare payments, and the workings of the fiscal stabilizers; second, because easing credit conditions will help stimulate housing and make credit more readily available to support business and consumer spending generally; and, third, because a substantial program of fiscal stimulus is in immediate prospect.

The staff's current projection incorporates considerably more fiscal stimulus than was the case 4 weeks ago. After analysis of the budget document, we have raised Federal spending, in NIA terms, by \$13 billion for the remainder of fiscal 1975 and by \$15 billion for fiscal 1976. This upward adjustment mainly reflects our judgment that most of the \$17 billion in spending cuts proposed by the President will not be approved, and also that unemployment insurance and related payments will be substantially more than has been budgeted due to the greater-than-expected weakness in the economy. On the receipts side, we have incorporated the Ways and Means Committee tax proposals rather than those recommended by the President. These call for both rebates and tax rate reductions aggregating \$20 billion in calendar 1975, but with tax withholding schedules set to give up roughly double the proposed \$8-1/2 billion annual rate of reduction in personal tax rates during the second half of the year.

On the assumption that something like these tax proposals will be enacted promptly, there will be a very large rise in after-tax incomes during the late spring and summer. Our projections are that disposable personal income will rise at a \$31 billion rate in the second quarter, reflecting about half of the rebate

payments, and by an additional \$42 billion rate in the third quarter, as the rebates are completed, the lower tax withholding schedule takes effect, and social security benefits are raised to reflect past increases in the consumer price index. Sudden cash injections of this size will substantially raise the rates of personal saving, which we expect to be over 10 per cent during the summer. But it should also bring a significant rise in consumption as the year goes on; we have projected increases in consumer spending of more than 10 per cent in both the third and fourth quarters.

Higher final sales should, with a lag, help bring the inventory liquidation to a halt, as businesses raise production schedules in response to better sales and begin to revise upward their inventory targets in light of the improved market environment. Higher production and sales, along with the assumed increase in the investment tax credit to 10 per cent, should in turn lead to a resumed uptrend in capital spending. And housing starts, because of easier credit conditions and improving consumer confidence, are expected to be moving up sharply again by the second half of the year. The result of all this should be a considerable pickup in over-all economic activity--we are projecting that the real GNP will rise at close to a 6 per cent annual rate, on average, in the third and fourth quarters of the year.

Such an increase in real activity would not add much to the number of jobs, however, because productivity of the work force is likely--as in the past--to improve significantly with the initial pickup in output. Therefore, we expect the unemployment rate to level off, or perhaps drift only slightly downward, from the 9-1/2 per cent level. Moreover, there is serious risk that the recovery will lose strength in 1976, if the temporary tax cuts are withdrawn as scheduled and as credit markets tighten if present monetary policy targets remain unchanged. Looking ahead as far as 1976, of course, there will be ample time for a change in policy assumptions.

What we foresee, in sum, is a strong current downswing in the economy that is likely to be reversed later this year, primarily as the result of substantial fiscal

stimulus. The ensuing recovery could be fairly vigorous, but it is apt to lose strength unless the fiscal stimulus is continued and even increased over time, or unless the forces of expansion catch hold and cumulate in the private sector. Because of the stimulative fiscal actions assumed, as well as the shortfall of revenues and additional expenditures that result from the weakness in the economy, a very large budget deficit seems inevitable. We have projected NIA deficits of \$75 billion in calendar 1975 and \$65 billion, annual rate, in the first half of 1976. Once economic recovery begins to take hold, and private credit demands expand, the continuing financing need associated with this deficit poses the clear danger that credit market conditions will tighten and tend to choke off recovery in the private sector.

Monetary policy, even with its well-known lags in impact, thus has an important supportive role to play in ensuring the ending of the downturn and assisting in the subsequent recovery. For now, the trend towards lower interest rates and easier credit conditions needs to be perpetuated through the provision of ample liquidity, which should work gradually to break down the present resistance to lending and lead to the adoption of more liberal credit standards. Later on, monetary policy will need to resist any significant premature tightening in credit conditions, as the recovery gathers force.

It appears to me that there is now considerable room for an accommodative monetary policy. Real progress has been made on the inflation front, as not only prices but also wage rate increases are responding to the bleak economic situation. The staff has moderated further the projected rate of inflation, but I am not certain that we have yet made sufficient allowance for the effects of reduced inflation and very high unemployment on the pace of the wage rate advance. Moreover, with the economy operating so far below its potential, and projected to continue so throughout at least the next year and a half, there would seem to be scope for a substantially more robust recovery than we have anticipated, should it develop, without at the same time exacerbating appreciably our underlying inflationary condition.

2/19/75

-34-

Mr. Hayes inquired about the staff's expectations for the rate of increase in hourly compensation over the next 18 months. With respect to the behavior of prices, he asked whether the temporary rebates that had been announced for autos and some other goods were of sufficient importance in the recent moderation in the rise in prices to give a misleading impression of the degree of improvement once the rebates were eliminated.

In response, Mr. Partee noted that the staff had assumed a gradual decline in the rate of increase in the adjusted index of average hourly earnings from an annual rate of a little above 8 per cent in the first quarter of this year to about 7 per cent in the first quarter of next year. Over the last 3 months, however, the index had risen at an average rate of not much more than 7 per cent--down from rates of 12 and 10 per cent, respectively, over the second and third quarters of last year. Looking ahead, the effect that an unemployment rate as high as 9-1/2 per cent might have on the rate of increase in hourly compensation was uncertain because of the absence of previous postwar experience to go by. It was possible that such a high rate of unemployment in combination with improvement in the behavior of the consumer price index might bring about more of a slowing in the rate of increase in hourly earnings. If the rise in the earnings index slowed to

a 5 or 5-1/2 per cent rate by the time recovery in activity got under way, unit labor costs actually would be declining. Such a development would have an important effect on the behavior of prices.

Mr. Partee agreed that for a short period the price rebates and other promotional sales efforts might bring about a slower rate of increase in the consumer price index than would persist over the longer term. However, the rebates had not yet been reflected in the behavior of the CPI, since January data--not yet available--were the first that could be affected.

Mr. Partee added that the recession appeared to be having a considerable effect on demands for foods and on their prices. Demands had been shifting to lower grades and to lower-cost substitutes, with the result that food prices had not been rising as fast as the staff had expected. He had been told that such shifts in the composition of sales had been responsible for a 2-1/2 per cent drop in January in one large grocery chain's internal index of prices based on total receipts per ton of foods sold. Developments of that sort, should they continue, would cast doubt on the staff's earlier expectation that food costs would rise substantially as the year progressed.

Mr. Hayes then asked for the staff's expectations for short-term interest rates toward the end of this year.

Mr. Partee replied that M_1 growth of 6 per cent this year, as assumed for the projections, along with the projected growth in nominal GNP, suggested that short-term interest rates would reach their lows in the second quarter, and then would rise modestly in the third quarter and substantially further in the fourth quarter. By the end of the fourth quarter, if not sooner, rates probably would have risen sufficiently to reduce considerably inflows of consumer-type time and savings deposits to banks and nonbank thrift institutions.

Chairman Burns commented that the actual size of Federal budget deficits and borrowing needs would have an important bearing on the course of interest rates. The staff had estimated budget deficits of \$37 billion and \$78 billion for fiscal years 1975 and 1976, respectively. After adding the deficits of all other budget agencies and Government sponsored corporations, the totals were \$64 billion for fiscal 1975 and \$95 or \$96 billion for fiscal 1976. Moreover, he thought the staff had underestimated the size of the budget deficits that would be realized in those 2 years.

Mr. Coldwell asked Mr. Partee whether he saw evidence of a cumulative downward spiral in this recession.

Mr. Partee replied that all the elements of a cumulative decline were in evidence. Because of the weakness in final sales,

2/19/75

-37-

inventory adjustments were becoming larger, and there were increasing indications of second and third rounds of cutbacks in capital spending plans. The current situation differed from developments in the 1930's in that personal income was declining much less than output, reflecting mainly the various Governmental programs designed to sustain personal income. Therefore, he expected the decline to be self-limiting.

In response to further questions by Mr. Coldwell, Mr. Partee said consumer spending in nominal terms, after having declined in the autumn, had been maintained in recent months, in part because of the support to personal income provided by unemployment compensation and by supplementary unemployment benefits in the automobile industry. However, consumer spending in real terms had been drifting downward, and that weakness in final demands was having an effect on the size of the inventory adjustment under way and on business capital spending plans. It was possible that the recession in activity would develop such momentum that consumers would not be inclined to increase spending, even in response to tax rebates and reductions. However, he believed that the supports to personal income would facilitate the inventory adjustment and limit the cumulative character of the decline in activity, and it was very likely that the fiscal

stimulus--assuming prompt enactment of something like the House Ways and Means Committee's program of tax reductions--would raise after-tax incomes enough in late spring and summer to bring about an expansion in consumption expenditures.

Mr. Coldwell remarked that he was disturbed that the tax reductions would not affect after-tax incomes until late spring and wondered whether that would be soon enough to prevent a cumulative deterioration in the economic situation.

Mr. Morris observed that projections made using the Federal Reserve model without any judgmental modifications suggested that the upturn in activity in the second half of this year would be much more sluggish than that projected by the Board's staff; it indicated real rates of growth of 2.3 and 3.5 per cent in the third and fourth quarters, respectively, compared with rates of 5.1 and 6.5 per cent projected by the staff. If the model proved to be correct--and he believed that in recent months it had performed better than the judgmental projections--the unemployment rate would rise above 10 per cent. He asked about the degree of confidence that the staff attached to its projection for the second half and about the probable direction of errors in the projection.

Mr. Partee replied that the projection produced by the model had some elements of weakness and some of strength that the staff had not been able to accept; for example, it had indicated a considerably stronger recovery in housing than the staff was projecting. In any case, it seemed to him more likely that the upturn, if it developed, would be stronger rather than weaker than that projected by the staff, because upturns as well as downturns typically had cumulative aspects.

Mr. MacLaury remarked that using the Federal Reserve model, consumer spending was projected to be about \$12 billion lower in the fourth quarter of this year than in the staff's judgmental projection, and he inquired about the difference.

Mr. Partee said that in the judgmental projection the rate of increase in prices was slower than that indicated by the model; in real terms, the two projections of consumption expenditures were not greatly different. In general, the judgmental projections and the model had been coming closer together over the past few months. The model did suggest that the unemployment rate would rise above the judgmental projection's peak of 9.5 per cent in the third quarter, but in his view, the model was not capable of capturing the dynamics of the recovery,

2/19/75

-40-

whenever it might develop, any more than it had been able to capture the dynamics of the downturn that had occurred.

Chairman Burns remarked that the staff projection contained an abnormally high saving rate in the second half of this year, which suggested that the expansion in consumption expenditures might prove to be greater than projected.

Mr. MacLaury then inquired about the latest projections of exports, which were substantially lower than the projection of a month ago.

Mr. Bryant commented that the projections of exports had been lowered somewhat in nominal terms, and substantially in real terms, from those of a month earlier. At the same time, however, the projections of imports also had been reduced sharply. The trade balance was projected to remain in deficit at an annual rate of about \$7 billion. The deficit on goods and services was projected to increase somewhat throughout this year, in large part because of a decline in investment income associated with oil.

Mr. Wallich observed that it was sometimes said that the large Federal deficit in prospect would not be as stimulative as it might appear to be because most of it resulted from a decline in the tax base rather than from deliberate increases in expenditures

2/19/75

-41-

or reductions in tax rates. A table in the green book,^{1/} for example, indicated that the economic stimulus or net change in tax receipts in fiscal year 1976 that would result from Administration tax proposals amounted to \$10 billion. However, that did not take into account certain other developments which had effects equivalent to reductions in taxes. For example, some corporations were shifting their inventory accounting from FIFO to LIFO, which would tend to eliminate inventory profits and reduce their tax liabilities. For corporations in general, inventory profits were projected to diminish from an annual rate of more than \$51 billion in the third quarter of 1974 to less than \$11 billion in the fourth quarter of 1976. Since the inventory profits last year had been unreal and had made no contribution to cash flow, in effect the tax rate on true profits had been increased significantly, and now the sharp decline in inventory profits would bring about a reduction in the tax burden on true profits. If reductions in Federal tax receipts arising from those developments were added to the portion of the deficit resulting from deliberate actions, the stimulative portion of the deficit would appear to be much larger.

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

2/19/75

-42-

Chairman Burns remarked that Mr. Wallich's argument could be extended to the personal income tax, because of the abatement of the rate of inflation.

Mr. Partee agreed that the decline in inventory profits had the effect of reducing the burden of the corporate income tax, although he did not know how large the effect would be. With respect to the table in the green book, it represented no more than an attempt to identify the net reduction in tax receipts that would result if the tax proposals of the House Ways and Means Committee were enacted. He did not agree with the notion that increases in the deficit resulting from operation of the automatic stabilizers had no economic effects. As indicated in another table in the green book, the high employment surplus or deficit was projected to move from a surplus at an annual rate of \$19 billion in the fourth quarter of 1974 to a deficit of \$16 billion in the fourth quarter of 1975. That represented quite a bit of fiscal stimulation.

Mr. Mitchell asked how the prospective deficit compared with deficits in previous recessions, in relation to the size of GNP.

Chairman Burns said the prospective deficit was larger, although not dramatically so, than the largest that had occurred in the past, except for the period of the second world war.

2/19/75

-43-

Mr. Black observed that the projected inventory liquidation had been equalled, in relative terms, only in the recession of 1953-54, and liquidation then had been accompanied by considerable improvement in the behavior of the GNP implicit deflator and by a decline in interest rates. He asked whether the downward revision in the fixed-weight deflator in the latest staff projections had resulted in large part from the increase in the rate of inventory liquidation.

Mr. Partee said he would agree with Mr. Black's inference, in the sense that market conditions in many cases would not permit raising prices in response to increases in costs and the inventory situation was a major element in those market conditions. Although the staff had reduced the projected rise in prices, the latest projection might still be on the high side, owing to the food price developments that he had mentioned earlier. Last week, the Department of Agriculture had reduced its forecast of food prices to about the rate of increase reflected in the staff's latest projection, and the staff now would thoroughly reconsider its own projection to determine whether the rate of increase in foods should be reduced further.

2/19/75

-44-

Mr. Bucher noted that in analyzing the factors underlying the sluggish growth in the monetary aggregates recently--particularly in M_1 --some observers suggested that a primary cause had been the large growth in the currency component, which had been on the order of 10 per cent in 1974. Growth in currency, which had accounted for an unusually large part of the increase in M_1 , did not add to the base permitting a multiple expansion in loans and bank credit, as did additions to demand deposits and to other deposits. M_1 currently totaled over \$280 billion, of which nearly \$70 billion--a not insignificant amount--was currency. He asked if the staff thought that the larger relative increase in currency had had any short-term effect on the growth of the monetary aggregates.

In reply, Mr. Partee observed that such analyses frequently attracted the most attention just about the time that the developments that provoked them disappeared. Since December growth in currency had been slow; he recognized, however, that monthly rates of change were quite volatile. In any case, the theory was incorrect; it was based on an assumption that in its open market operations the System failed to take account of the reserve drain attributable to expansion in currency outside the banks. In fact, System operations

2/19/75

-45-

automatically compensated for such changes in currency, and staff projections of reserves always took such changes into account.

Mr. Eastburn commented that analysis of past business cycles revealed that an increase in the relative demand for currency was characteristic of the recession phases. Moreover, past experience suggested that the rise in currency relative to demand deposits still had some way to go, even though growth in currency had been slow lately. Such a development would have significance for the volume of reserves that would need to be provided by System operations to achieve any particular rate of growth in the monetary aggregates.

Mr. Axilrod remarked that because day-to-day operations were geared to the Federal funds rate, the effects on reserves of changes in currency outside the banks were automatically offset by open market operations, as Mr. Partee had mentioned earlier. If Desk operations were geared to a reserve aggregate target, unanticipated growth in currency would result in overshooting the desired growth in the money supply. If, on the other hand, operations were geared to a monetary base target, unanticipated growth in currency would lead to a shortfall in money supply growth.

Mr. Eastburn commented further that at the last Committee meeting there had been some statements to the effect that the System simply had not provided the banks with an adequate amount of reserves, in part because of the behavior of the multiplier. If there was merit to that view, it had implications for policy.

Mr. Partee remarked that growth in currency had not been responsible for the observed behavior of reserves; if anything, it was the funds rate constraint that had been responsible.

Mr. Winn observed that the current weakness in the volume of goods being hauled by truck was sobering in view of the past relationship between truck tonnage and industrial production. He asked whether the weakness had been caused primarily by the inventory adjustment.

Mr. Partee replied that the behavior of truck tonnage reflected the large downward adjustment in output that was under way, in part because of inventory liquidation. As he had noted earlier, the industrial production index had declined 9 per cent in the 3 months from October to January; at an annual rate, that was a decline of close to 40 per cent.

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 January 21 through February 12, 1975, and a supplemental report covering the period February 13 through 18, 1975. Copies of both reports have been placed in the files of the Committee.

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

Growth of the monetary aggregates fell far short of the Committee's desires over the period since the Committee last met, with the latest estimates indicating a 2 to 3 per cent decline for M_1 for the 2-month period ending in February. In response to the weak incoming data the Desk became progressively more accommodative in the provision of reserves, pushing the rate on Federal funds to the 6-1/2 per cent lower end of the Committee's range by the second week after the meeting and then, after the Committee concurred on February 5 with the Chairman's recommendation, to the new lower limit of 6-1/4 per cent. Current projections indicate a pick-up in growth rates for the months ahead, but given the weakness in the economy and the slackening of loan demand, the relationships between interest rates and monetary aggregate growth rates have been especially hard to predict of late.

While the performance of the aggregates was disappointing, interest rates in all maturity areas declined sharply over the period. In Friday's auction, an average rate of 5.41 per cent was established for the 3-month Treasury bill, down nearly a full percentage point from the rate established just prior to the last meeting. The cut in the discount rate and Desk operations over the period tended to confirm market expectations of a continuing easing of monetary policy in response to the weak economy and to the sluggish

monetary growth. Reflecting greater reserve availability relative to demand, the banking system has slipped into a net free reserve position over the past 3 weeks and borrowing at the discount window has been minimal.

As short-term interest rates declined, incentives were provided for investors to lengthen maturities, and conditions in the private debt markets improved substantially. Against this background the Treasury's February refunding was a success, with all three issues sold by the Treasury moving to significant premiums. Today's auction of two short-term notes by the Treasury to raise \$3 billion in new cash is expected also to be very successful and the rate ideas are well below rates on comparable maturities in the market right now, which is a little surprising. Concern over the size of Treasury financing in the offing caused only momentary lapses in market confidence. Steady retail demand (including that for bank investment portfolio) will be required, however, if the market is to meet the Treasury's needs without some setback to the current interest rate trend. Some market participants are not too sanguine about the outlook, particularly if monetary growth resumes, as many expect. That the market is still sensitive was evidenced by the sharp (but short-lived) reaction to our modest outright sales of bills in the market on February 6. One constructive result of that sale was a reminder to market participants that continuing distribution of Treasury debt is essential if the market is to handle the volume of Treasury debt that lies ahead.

A large volume of open market operations was required over the period to achieve the successively lower Federal funds rates that the sluggish monetary growth rates called for. Unexpected variations in the supply of reserves through market factors, as usual, tended to complicate operations and added to their size. Most operations were of a temporary nature with repurchase agreements amounting to over \$15 billion and matched sale-purchase transactions to about \$7.5 billion. Of these matched transactions, over half were conducted with foreign accounts, reflecting their desire to keep continuously invested on a temporary basis pending more permanent investment decisions.

Looking ahead, we have an unusually large discrepancy between New York and Board staff reserve projections. As of yesterday morning, our estimates in New York indicated a need to supply reserves in the statement week ending today and a very large reserve need in the weeks ahead. Board staff estimates, on the other hand, indicated no reserve need for the current week and a very large need to absorb reserves in the weeks ahead. Discrepancies in reserve projections are by no means uncommon but a difference of as much as \$2 billion in weekly averages is a bit unusual. Most of this difference reflects a different appraisal of the Treasury's cash position through the end of this month and in early March. As the day-to-day results come in, our estimates, I'm sure, will come closer together. But in the meantime, we will have to rely to a considerable extent on what the market can tell us about the true reserve situation. These discrepancies, together with the large daily misses we've had in estimates of the market factors affecting reserves--and misses of \$1 billion are no longer uncommon--have already caused our projectors to get together to review their procedures, and perhaps a somewhat broader study might be called for. Better reserve projections appear especially important in light of the emphasis given to reserve measures by the Subcommittee on the Directive.

In response to a question by Chairman Burns, Mr. Holmes said that for the current statement week actual reserves appeared likely to fall midway between the New York Bank and Board staff projections--a fairly typical outcome.

Mr. Mitchell asked about the extent to which System purchases of securities could focus on longer-term issues without impairing the effectiveness of operations.

In response, Mr. Holmes observed that, given the prospective volume of Treasury financing, much of which would be in the

intermediate- and long-term maturity area, opportunities to buy coupon issues could be virtually unlimited over the next 18 months. Of course, it would be desirable to pay some attention to the Treasury bill market, particularly since the supply of bills had been increasing fairly rapidly--at a rate of about \$400 million a week. If foreign demands for bills were strong, however, there would be no problem in that area.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period January 21 through February 18, 1975, were approved, ratified, and confirmed.

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

The issues discussed in the blue book^{1/} are generally the same as have been presented for Committee consideration in the past several meetings. It may be well to remind the Committee of the basic assumptions behind the blue book analysis. First, the staff projection of GNP is taken as given. Second, it has also been assumed that the exceptionally rapid January decline in M_1 does not reflect any fundamental shift in attitudes toward cash and that a more normal relationship will be reestablished between the transactions demand for money, narrowly defined, and nominal GNP. Finally, the Federal funds rate specified has been assumed in the current blue book to prevail over the whole projection period.

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

Because projections of GNP have weakened, we have indicated at successive meetings of the Committee that lower Federal funds rates would be required to attain desired growth in the aggregates. We have also presented alternatives that stretched out the time period over which desired growth might be attained. Since we have assumed in these alternatives that the Federal funds rate is unchanged over the projection period, growth rates in the monetary aggregates--and in M_1 in particular--may vary, of course, with deviations of GNP from projections, with random shifts in money demand, or with a basic shift in public preferences for liquidity.

Alternative A^{1/} indicates the sharp drop in the funds rate over the next few weeks that appears needed if the Committee wishes to attain a 6 per cent M_1 growth rate by mid-year. But because the economy is projected to show a substantial rebound by the third quarter, this alternative implies an extremely rapid rate of growth in monetary aggregates by summer, assuming a lower Federal funds rate. Alternatives B and C specify a smaller decline in the Federal funds rate. In these alternatives a growth rate for M_1 in the 6 per cent area from a December 1974 base would be attained in late summer or fall, assuming that GNP and associated transactions demands for cash rebound as projected. Alternative D represents the implications of what would in effect be a slight tightening of the money market from conditions of recent days and as compared with market expectations.

I would just like to add one final point, which has already been touched on by Mr. Mitchell. In providing reserves over the period ahead, it may be desirable to place some emphasis on purchasing Treasury coupon and Federal agency issues. This would, to a degree, take some pressure off long-term markets. It would thereby facilitate the large-scale substitution of long-for short-term debt that is being undertaken by corporations and would, at the margin, help lower mortgage interest rates. At the same time, there would be a degree less downward pressure on short rates, but probably not by so much as to retard savings inflows to banks and thrift institutions significantly or to moderate downward pressures on key institutional rates.

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

Mr. MacLaury remarked that, as he had mentioned at last month's meeting, a chart portraying the long-run growth paths for M_1 associated with the various policy alternatives had been included in the blue book at times in the past. While he recognized that such charts might suggest that the Committee placed more emphasis on M_1 than any member would favor, he nevertheless found them analytically useful.

Mr. Balles observed that he too would find it useful to have such a chart for M_1 -- and if possible, for M_2 also. The main value of the charts was to help the Committee focus on the longer-term trends, which were the important aspects of its policy decisions, and to avoid excessive concentration on short-term fluctuations.

Chairman Burns remarked that even if such charts were useful to only one Committee member they should be supplied. He thought, however, that they might best be distributed separately rather than included in the blue book.

Mr. Axilrod noted that, as the Committee was aware, the relationship between M_1 and M_2 was continually subject to change. That fact would complicate the proposed chart.

In response to a question by Mr. MacLaury, Mr. Axilrod said that alternative A in the blue book was consistent with the

6 per cent December-June M_1 growth path the Committee had adopted at its last meeting. M_2 was somewhat higher, however, because of a change in the relationship between M_1 and M_2 .

Mr. MacLaury then said he wanted to emphasize a point Mr. Axilrod had mentioned in his earlier statement--namely, that the long-run growth rates in the blue book had been based on the assumption that the Federal funds rate remained unchanged throughout the projection period. He realized that such a simplifying assumption was probably necessary; indeed, he could not suggest a better assumption for the staff to make. Nevertheless, he wanted to clarify his own position by noting that, although he might favor a low funds rate now, he did not intend to bind himself to a low funds rate over the next three quarters, particularly in light of the rapid third-quarter growth in M_1 associated with that policy prescription.

Mr. Axilrod said the staff had explored several different methods of formulating the policy alternatives, and had concluded that the current format probably was the clearest. The text of the blue book did note that a substantial rise in the Federal funds rate might be necessary in late spring or early summer if the Committee adopted alternative A today, but then wanted to reduce M_1 growth in the third quarter from the rate of nearly 12 per cent shown under A to a rate closer to 6 per cent.

2/19/75

-54-

Mr. MacLaury asked Mr. Axilrod to define "a substantial rise" in the funds rate in quantitative terms.

In reply, Mr. Axilrod said preliminary work on that question suggested that an increase in the funds rate of, say, 4 to 6 percentage points would be necessary over the course of the summer if the third-quarter M_1 growth rate were to be reduced to around 6 per cent, on the assumption that the substantial rise in nominal GNP projected for that quarter in fact took place.

Mr. MacLaury then commented that, in his judgment, it would be absurd for the Committee to attempt to affect the money supply within a given quarter by raising the funds rate in that quarter; presumably, action should be taken sooner. The central question, therefore, was whether an upturn in the funds rate--from the low level implied in alternative A--beginning in the second quarter would choke off housing and dampen the recovery projected for the second half.

Mr. Axilrod replied that, indeed, one implication of the 6 per cent target for M_1 growth over the first half of 1975 associated with alternative A, and continuation of that rate in the latter part of the year, was extremely sharp variations in interest rates. To the extent that the Committee was unwilling to accept such rate fluctuations, alternative A might be, in a sense, an unreal option. The scenario implied by Mr. MacLaury, in which

the funds rate moved only moderately lower and rose somewhat earlier was, in effect, similar to that of alternative B. Under B, a 6 per cent growth in M_1 would be achieved over the first three quarters of the year rather than over the first half.

Mr. MacLaury then asked whether any analysis had been done regarding the recent decline in the real money stock as compared with the decline that had occurred in the early 1930's. He recognized, of course, that the two periods were quite different; for example, in the earlier period prices, as well as the nominal money stock, had declined rapidly.

Mr. Partee replied that Mr. Gramley recently had reviewed current developments relative to historical experience, including that of the 1930's. The recent decline in real money stock had been more rapid than in the 1930's for the reason Mr. MacLaury had noted--prices had fallen in the 1930's. He doubted that the experience in that earlier period was particularly relevant to the problems of today.

Chairman Burns observed that in his studies of the inflations of history he found that an identifiable pattern generally emerged: after a certain point, the real money stock diminishes rapidly; in response to the outcry from the business community--and from economists--that there is a shortage of money, the monetary

authority prints more money; subsequently, the rate of turnover increases, the rate of inflation increases, and the real stock of money falls still further. This process goes on until the stage of hyperinflation is reached and, as in Germany, the total real stock of money becomes virtually zero. Against that background, he thought the Committee should keep in mind that the concept of the real money supply was a slippery and dangerous one.

Mr. Black asked whether any specific assumptions had been made in the staff's projections regarding the investment of official foreign funds.

Mr. Axilrod responded that a neutral posture had been maintained in that regard; neither an acceleration of OPEC purchases, a substantial increase in purchases as a result of exchange market intervention, nor any sudden lack of interest in dollar assets had been assumed.

Chairman Burns then called for the discussion of monetary policy and the Committee's policy directive. He suggested that it would be helpful if in the course of their comments the Reserve Bank Presidents would express their views on discount rate policy.

Mr. Mitchell said he need not document the statement that over the past year there had been substantial revisions in the

2/19/75

-57-

economic projections made by the staff and by those members of the Committee who developed their own projections. He did not intend any criticism by that statement, but the fact remained that the projections had been substantially off the mark with respect to the level of unemployment and the rate of inflation that would be associated with the Committee's policy. Because economic visibility was still highly limited, he viewed the choice among the alternative longer-run targets for the monetary aggregates as highly hypothetical.

In his judgment, Mr. Mitchell continued, the Committee should focus primarily on the Federal funds rate at this time. He would prefer a funds rate range of 5-1/4 to 6-1/4 per cent, with an initial move aimed at dropping the rate to just below 6 per cent. He would encourage the Manager to concentrate his securities purchases as far as possible in the longer-term area; if some easing in longer-term rates developed, he would be prepared to leave the funds rate at just under 6 per cent. While a dramatic reduction in the funds rate might have an immediate impact on those portfolio managers who were now sitting on the sidelines, because of the risk of fueling inflation he would prefer to move more slowly and to use time as an ally in affecting investor behavior. For the operational paragraph of the directive, he favored the wording of alternative C.

In response to a question by Mr. Sheehan, Mr. Mitchell said his primary objective was to foster a decline in longer-term interest rates; he was not particularly concerned with the monetary aggregates at this point. He would be content to see the funds rate stabilize in the 5-3/4 to 5-7/8 per cent area if there was some movement in longer-term rates, but if no such effects were evident within, say, 2 weeks, he would favor moving the funds rate a little lower.

Chairman Burns remarked that it might be helpful if he read off the recent growth rates for a few of the monetary variables that the Committee would be discussing. In the months of December and January, respectively, the annual rates of growth were 0.6 per cent and -13.3 per cent for demand deposits; 7.1 and 3.5 per cent for currency; 2.9 and 13.5 per cent for time and savings deposits other than large CD's; 67.4 and 34.6 per cent for large CD's; and 8.5 and 9.5 per cent for deposits at nonbank thrift institutions.

Mr. Balles referred to Mr. Partee's earlier comment that there was considerable room for an accommodative monetary policy. He asked whether Mr. Partee was thinking in terms of continuing to aim for growth in M_1 over the 6-month target period at a 6 per cent rate, or whether he favored aiming for growth at a rate in, say,

an 8 to 10 per cent range, in order to compensate for earlier shortfalls.

Mr. Partee replied that his thinking in some respects was similar to Mr. Mitchell's. He believed that the Committee's primary goal at this point should be a further reduction in interest rates and a further easing in credit conditions. Lower rates would be necessary in order to provide the Manager some leeway to supply reserves, which he had been unable to do recently simply because market rates had fallen more sharply than the "administered" Federal funds rate acceptable to the Committee. He was not sure he would recommend the specific course Mr. Mitchell had described because of the possibility that, with credit demands quite weak, market rates would continue to move down. He believed it was necessary not only to foster credit easing now but also, as the Chairman had said on numerous occasions, to avoid a quick and substantial tightening in credit conditions when the upturn in economic activity began. In essence, he had used the term "accommodative policy" in the old sense, which implied no great concern about the behavior of the aggregates--either now, when they were on the weak side, or later on in the year, when they might well be strong.

2/19/75

-60-

Mr. Balles observed that one element restricting credit availability in the economy was the pressure--justifiable, in his judgment--that had been brought to bear upon commercial banks to achieve adequate capital relative to the expanding volume of their assets. Some of the larger banks in particular still were following quite restrictive loan policies, because they were concerned about the rising volume of classified assets in relation to capital. Consequently, the dramatic decline in short-term interest rates that had occurred was not fully indicative of greater credit availability. The availability of credit had improved for the most credit-worthy borrowers but not for those in situations of somewhat greater risk. In the circumstances, the System had to take action, and he did not believe that it was in the position of pushing on a string. Since banks had now reduced their borrowings from the System to a minimal working level, in his judgment any additional reserves provided by the System would be employed--in the early stages, at least to purchase securities if not to expand loans--and that would help to combat the recession.

Continuing, Mr. Balles remarked that in light of the great uncertainty about the meaning of the aggregates--as Mr. Mitchell had noted in his learned speech at the University of Iowa recently--

he had had his staff examine the ability to predict real GNP on the basis of the behavior of M_1 , M_2 , and M_3 and various other measures of money. Somewhat to his surprise, M_1 still performed better than M_2 , particularly in 1974. As a predictor of real GNP in 1974, M_1 had an average error of .836 per cent, while M_2 had one of 2.79 per cent. Other measures were examined for 1974, including M_1 plus CD's, M_2 plus CD's, and M_3 , but M_1 performed substantially better than the rest. Consequently, he could not calmly accept the recent shrinkage in M_1 and was anxious to renew expansion.

Accordingly, Mr. Balles said, he favored alternative A. For many months M_1 had fallen below the Committee's targets, and now both the economics of the situation and Congressional concern pointed in the direction of pursuing the monetary growth rates under alternative A. To achieve those rates of growth, both for the short run and the longer run, he would accept whatever decline in the Federal funds rate was necessary.

Chairman Burns remarked that Committee members wanted to follow the policies that they believed to be appropriate in the current economic situation; they and the country would have to live for a long time with any mistakes that they might make. It would be a tragic mistake to yield to political pressures; the political pressures of today would not necessarily be those

2/19/75

-62-

of tomorrow. The Congress had established the System as an independent entity, and the Committee ought to live up to the responsibility imposed by that independence.

With regard to the discount rate, Mr. Balles commented that he, and perhaps other Bank Presidents, would find it helpful to discuss general policy with Board members in an effort to improve communication. At present he was considering a recommendation to his directors that they propose a cut of one-half of a point, so that the rate would no longer provide an incentive for banks to repay borrowings, thereby shrinking total reserves. However, he was reluctant to make such a recommendation until he knew more about the Board's thinking.

Chairman Burns remarked that, while better communication was desirable, it was often difficult to achieve. At the moment, for example, he did not know Board members' views on the discount rate. And that was often the case.

Mr. Clay observed that at the moment attempting to achieve growth in M_1 was like the Ogden Nash description of trying to get ketchup from a bottle: "You shake and shake and shake the bottle, at first none will come and then a lottel." Economic activity had declined more rapidly than had been expected, and the Committee had underestimated the decline in interest rates needed to achieve the desired rates of monetary growth. Now, prudence would indicate

that the System should provide reserves in sufficient volume to bring about a restoration of growth in the aggregates, and that would require a further decline in the Federal funds rate. However, the Committee should take care not to over-react. It was just when one was convinced that nothing would flow from the bottle that the ketchup poured out. As people became convinced that fiscal policy would be strongly expansive, and as economic activity turned up in response, growth in the aggregates was liable to become stronger than now expected, and the Committee might confront the difficult problem of having to make interest rates rise rapidly.

Consequently, Mr. Clay said, he favored specifications between those of alternatives B and C--specifically, a February-March range of 5-3/4 to 7-1/4 per cent for M_1 and a range of 5 to 6 per cent for the funds rate. If growth in the monetary aggregates did not respond promptly, he would move the funds rate down toward the lower limit rather soon. As for the language of the directive, he preferred alternative A, but he could accept alternative C.

Chairman Burns remarked that he had just received a note to the effect that new deposit data for the week ending February 12, 1975, indicated that M_1 was much stronger than had been reported earlier, by perhaps as much as \$1 billion.

Mr. Holland observed that he agreed with much that had been said by Messrs. Clay and Mitchell. It was essential that the

2/19/75

-64-

Committee aim at attaining financial conditions that would facilitate recovery without fueling a resurgence in inflation. The key problem was the form of operating instructions to the Desk designed to achieve that policy objective; the specifications adopted at the last meeting had proved to be more inconsistent than at any time in his memory. If the aggregates now performed in accordance with the staff projections in the blue book--and he believed that they would--vigorous growth in the monetary aggregates would ensue. But the Committee had to take account of the possibility that monetary growth in February again would fall short of the projections, and either the lower limit of the funds rate range had to be set low enough to allow for that possibility, or in the event that incoming data indicated that growth was continuing to fall short, the date for the next Committee meeting should be advanced.

In general, Mr. Holland said, he liked Mr. Mitchell's proposal for operating instructions to the Desk. Specifically, he favored a range of $5\frac{1}{4}$ to $6\frac{1}{4}$ per cent for the Federal funds rate, and would move the rate down to $5\frac{3}{4}$ per cent and watch developments. He would associate that funds rate range with the specifications for the aggregates under alternative B. Like Mr. Mitchell, he would give more emphasis to purchases of longer-term securities in the process of providing reserves. With respect to the longer-term targets, it would be desirable to lengthen the applicable time span to 9 months,

from 6, to allow time for growth in the aggregates to catch up gradually. If the Committee did not wish to lengthen the span, it ought to drop the longer-term targets altogether. He would be unhappy about specification of 6-month targets as low as those of alternative B, and he suspected that most members of the Committee would not like to have such growth rates on the record. The 9-month targets under alternative B--6 per cent for M_1 , 8-1/2 per cent for M_2 , and 7 per cent for the bank credit credit proxy--were more or less consistent with the longer-run targets specified at the last meeting, and they represented an orderly way of adjusting to the recent behavior of the aggregates and of helping to facilitate recovery in economic activity without going too far.

Mr. Wallich commented that the situation in prospect had changed, and the case for strong efforts to improve liquidity had weakened considerably: the Federal budget deficit now in view was larger than before, posing dangers of increased inflationary pressures; and the projection of economic activity, while indicating less strength in the near term, suggested a more vigorous upturn in the second half of the year. Furthermore, the foreign exchange value of the dollar had declined, and the System had embarked on an operation to provide some support in the market--although, of course, that operation could be discontinued.

Mr. Wallich observed that in general he favored alternative C, and he preferred that the funds rate remain above the lower limit of 5-1/2 per cent under that alternative. He favored the language of alternative A for the operational paragraph, because the Committee was indeed seeking "more rapid growth in the monetary aggregates."

Mr. Black remarked that, like Mr. Clay, he believed that growth in the monetary aggregates was on the verge of picking up-- for the same reasons that he had outlined at the last meeting of the Committee, including in particular the lagged response of the aggregates to the substantial declines in short-term interest rates that had occurred. Consequently, he was in general agreement with Mr. Holland's views on policy. He would retain 6 per cent as the longer-run target for M_1 growth by stretching the period out to 9 months. He favored a range of 5-1/4 to 6-1/4 per cent for the funds rate, although he would not be inclined to move down very rapidly from the current level, and he would associate that range with the 2-month ranges for the aggregates under alternative B. For the operational paragraph of the directive, he preferred the language of alternative A.

Concerning the discount rate, Mr. Black commented that in his judgment a further reduction should hinge in large part on the sort of international consultation that the Chairman had mentioned earlier. It would be preferable for interest rates abroad to decline

further before the discount rate was cut again. If such declines abroad were to be expected shortly, he would be inclined to recommend a reduction of one-half of a point this week; if they were to be expected somewhat later on, he would wait for clear signals and then cut the rate promptly.

Mr. Eastburn observed that, in reaction to the discussion thus far, he would comment on four major issues. First, he disagreed with those who would focus major attention on the Federal funds rate; it was such a focus that had been responsible for the shortfall in monetary growth and that would, if continued, lead to further difficulties in achieving the desired rates of growth. He agreed that a lower funds rate was needed, but he would give more emphasis to the need for faster growth in the money supply. Second, he would underscore Mr. Balles' remark that considerable empirical research had established a certain relationship between the narrower definitions of money and GNP. Until research had demonstrated a more stable relationship between M_5 or M_6 or M_8 and GNP, the Committee should continue to emphasize the narrower definitions. There was also a danger that the Committee would be subject to an accusation of switching to whatever definition of money might seem to suit its purpose at the time.

Continuing, Mr. Eastburn remarked that a great deal had been said about an over-stimulative fiscal policy, but the lessons of 40 years ago indicated that a stimulative fiscal policy was needed in a

2/19/75

-68-

period of severe recession. Such a policy was now in prospect, and for the first time the staff was projecting a deficit on the high-employment basis. Finally, while the Federal Reserve System was an independent entity, its actions were being closely observed. He was concerned that there would be critical public reaction to continuation of a monetary policy that had produced very little growth in the narrow money stock over the past 6 months, a period in which the economy was moving into the worst recession since the 1930's. Continued pursuit of such a policy and failure to stimulate the desired rates of monetary growth promptly could have some undesirable long-run implications.

With those thoughts in mind, Mr. Eastburn said, he favored alternative A. He would press to achieve more rapid monetary growth as quickly as possible. Concerning the discount rate, he would--in the absence of any unforeseen development--recommend a cut of one-half of a percentage point to the directors of the Philadelphia Bank at their meeting tomorrow.

Mr. Kimbrel observed that price prospects suggested that inflation was diminishing. Consumer confidence was still weak, and the rebates on automobiles and other price cuts had not yet brought about a recovery in consumer spending. At the same time, he was mindful of the enormous Treasury deficits--with the strain they would exert on financial markets--and of the possibility of a spurt in monetary growth accompanied by a renewal of inflationary expectations. Accordingly,

2/19/75

-69-

he favored the specifications of alternative C, perhaps shaded a little in an easing direction. He would like to see the Federal funds rate stabilize at around 6 per cent, and he would prefer that the rate not back up at all from its present level. For the operational paragraph, he favored the language of alternative A. As for the discount rate, he felt that its impact was mainly psychological at present; taking foreign exchange considerations into account, he would advocate a steady but continuous move to a lower level--perhaps in more frequent steps of one-quarter of a percentage point rather than in steps of one-half of a percentage point.

Mr. Hayes commented that he would avoid a completely mechanistic approach in trying to achieve the desired rates of growth in the monetary aggregates. He would not want to see a further sharp decline in interest rates, for a number of reasons. The aggregates were likely to respond to the declines in short-term interest rates that had already occurred. There was reason to believe that the banks--after a period in which they had been trying to improve their liquidity and to slow growth in their liabilities in relation to their capital--would expand their assets as reserves became more abundant. Very large Federal deficits were going to have to be financed, and it would be undesirable for interest rates to back up sharply when those financings hit

2/19/75

-70-

the market with full force. Finally, the performance of the dollar in the foreign exchange markets had been distressingly weak, in association with the sharp drop in interest rates in this country. And as the Chairman had remarked at an earlier meeting, business and financial leaders tended to look upon the Federal Reserve System as the institution that was the bulwark against inflation.

Accordingly, Mr. Hayes said, he would lower the Federal funds rate only a little further; he favored the funds rate range of 5-1/2 to 6-1/2 per cent under alternative B, but he could accept Mr. Mitchell's proposed range of 5-1/4 to 6-1/4 per cent. Because interpretation of the aggregates was so uncertain at present and because the Committee, in his view, had been concentrating primarily on money market conditions, he would prefer to couch the operational paragraph of the directive in money market terms. Specifically, he favored language along the lines of Mr. Coldwell's proposal at the last meeting, and would say that "...the Committee seeks to achieve somewhat easier bank reserve and money market conditions, expecting a faster growth in the monetary aggregates." If the Committee preferred to couch the directive in terms of the aggregates, however, the language might include some reference to the importance of avoiding too sharp a

2/19/75

-71-

decline in interest rates. Among the alternatives presented by the staff, he preferred alternative A. In any case, he would include in the operational paragraph the phrase "taking account of Treasury financing activity," because Treasury financings would be frequent in the period ahead. He did not feel strongly about the choice of specifications for the aggregates, because in his view, rates of growth in the neighborhood of those indicated were not likely to be achieved in the period immediately ahead.

Concerning the discount rate, Mr. Hayes commented that a reduction of one-half of a percentage point probably was in order, because the Federal funds rate was about that much below the discount rate and was likely to decline further in coming weeks. However, he would not cut the rate this week.

Mr. Morris observed that nothing had happened in the 4 weeks since the last meeting to change his conviction that monetary policy over the past 6 months had been too restrictive. Now, the Committee's first priority should be to establish financial conditions that would assure an upturn in economic activity in the second half of the year. The risk that the unemployment rate would rise to a double-digit level was very real.

2/19/75

-72-

Continuing, Mr. Morris remarked that although he might have sounded like a monetarist in recent months, he did not believe in the black box of M_1 . Monetary policy affected economic activity through interest rates and the availability of credit. However, he accepted one monetarist doctrine that his 6-1/2 years on the Committee had demonstrated to be valid: monetary policy could not be described as restrictive or expansive solely on the basis of whether interest rates were rising or falling. The behavior of the aggregates was relevant to the Committee's consideration of what interest rate policy ought to be. Even though interest rates had declined sharply over the past 6 months, monetary policy had been too restrictive; growth in M_1 , M_2 , bank reserves, and bank credit had fallen considerably short of the rates that at the outset of the period Committee members in general would have judged to be appropriate. Clearly, the sharp reduction in interest rates had resulted primarily from the substantial decline in the demand for money and credit rather than from policy actions of the Committee.

Chairman Burns said he believed that Mr. Morris had overstated the case. The System had done a great deal to move interest rates down. If it had not moved the Federal funds rate down month after month, interest rates in general would not have declined so much.

Mr. Morris agreed that the Committee had acted to ease money market conditions. Nevertheless, the primary force pushing interest rates down had been the decline in the demand for money rather than the increase in the availability of reserves. Had the Committee wished to maintain a considerably higher funds rate in recent months, it would have had to contract the reserve base. He was particularly concerned about achieving more rapid expansion in reserves and in the money supply, because bank lending standards were much more restrictive now than they had been a year ago. For example, a major bank in Boston recently had turned down a substantial loan to a credit affiliate of a large national corporation--although a year earlier it would have welcomed the opportunity to gain the corporation as a customer--because it could have financed the loan only by increasing its borrowed money position, and its policy now was not to expand loans on that basis. He suspected that the same sort of thing had been occurring in other parts of the country.

Mr. Morris observed that the latest staff projections of the aggregates suggested that growth in M_1 would be substantial in the period ahead even without any further reduction in the funds rate and in other short-term interest rates, but he was not confident that those projections would be any more correct than similar ones

2/19/75

-74-

made in the past several months. At this point in the most severe recession in the postwar period, the System should pursue a more aggressive policy to reduce interest rates until progress toward the desired rates of monetary growth actually began to appear. Accordingly, he favored the specifications of alternative A. However, he would set the upper limit of the funds rate range at 5-3/4 per cent, rather than 5 per cent, because it would not be orderly to move the funds rate down immediately to 5 per cent from the current level of about 6-1/4 per cent. He would suggest that the Manager move the rate down immediately to 5-3/4 per cent and then use the full range if necessary to achieve the desired rates of growth in the aggregates. It was essential to stimulate expansion in bank loans and investments as well as in M_1 .

As to the discount rate, Mr. Morris said he was concerned that for the first time in his memory it was a penalty rate. As a result, borrowing from his Bank was confined to those member banks that could not borrow elsewhere. Of the 20 seasonal borrowing arrangements that the Boston Bank had made with commercial banks in resort areas, only one was in use, because the banks could borrow Federal funds at lower rates. Total borrowings from the System suggested that the situation was similar in other Districts. In his judgment, the discount rate should be held somewhat below

the funds rate so that access to the discount window would have some value to member banks. With regard to the mechanics of discount rate changes, he would urge that the Board on occasion table recommendations rather than respond immediately.

Chairman Burns commented that the Board often would prefer to table recommendations, but the members were concerned about the possibility of leaks during the period of delay. In addition, there was a potential problem of conflict of interest that arose because some directors of the Reserve Banks were commercial bankers. Therefore, it generally was desirable to minimize the interval between receiving and acting on a recommendation from a Bank.

Mr. Black remarked that the code used to transmit recommended changes in discount rates was in the Federal Reserve code book that was available to quite a few people in the System. He would suggest a change in procedures so that discount rate recommendations would be handled completely in a special code, with access strictly limited to officials with a need for the information.

The Chairman said the suggestion would be taken under consideration.

Mr. Mitchell asked Mr. Morris whether in his view the recent behavior of bank loans was attributable to weak loan demand or to reluctance of banks to meet the loan demand that did exist.

2/19/75

-76-

Mr. Morris replied that it was a combination of the two. Business loan demand was weak in part because interest rate differentials had shifted loan demands to the commercial paper market. In addition, bankers were reluctant to expand their loans, because they did not have funds available to lend. While they could borrow in the open market, they did not want to increase their borrowings. The banks had been told that they were over-extended, and they also were concerned about their positions. Security holdings of member banks--which generally rose in periods of recession as bank liquidity improved--had been declining; the decline was indicative of the banks' feeling that they were under considerable pressure.

Chairman Burns observed that the System had taken action to provide an enormous volume of nonborrowed reserves in recent months, and the banks had responded by reducing their indebtedness. Now, that phase was over, and the banks would respond to the provision of additional reserves by expanding either loans or investments. He thought it was unlikely that they would simply permit excess reserves to pile up.

Mr. Morris remarked that he was concerned that the Federal funds rate constraint would operate to limit reserve-supplying operations of the Desk.

Chairman Burns agreed that the funds rate constraint might limit reserve-supplying operations. However, even if the funds rate were allowed to fall to 4, to 3, to 2, or to 1 per cent, the monetary aggregates typically watched by the Committee still might not respond for a couple of months. Other aggregates that were not viewed as targets of the Committee might respond promptly, and after a month or two of very low interest rates, growth in M_1 and M_2 might be explosive. The explosion would lead to an upturn in short-term interest rates and, even worse, to a backing up of long-term rates even while economic activity still was declining. That was a risk that could not be ignored.

Mr. Mayo observed that in his view Committee members tended to worry too much both about how fast interest rates were rising when they were on the way up and about how fast they were declining when they were on the way down. While he would not advocate abandonment of the Federal funds rate constraint, he did not believe there was a risk that the funds rate would fall to 3 or 2 or 1 per cent under present circumstances; growth in the aggregates would be more responsive. However, he was not concerned that very rapid rates of growth would develop in the immediate future, given the gloomy outlook for economic activity. As yet, there was no assurance that the projected

2/19/75

-78-

upturn in activity in the second half of this year would actually develop, and it was important that monetary policy be expansive enough to contribute to the achievement of an upturn.

Accordingly, Mr. Mayo said, he would like to see M_1 on a 6 per cent growth path earlier than next September, and he favored specifications close to those of alternative A. A less expansive policy would risk contributing to a weaker economic situation than that portrayed by the staff projection. In line with his long-standing preference for wider ranges, he would specify 4-1/2 to 6 per cent for the funds rate and 5 to 8 per cent for growth in M_1 over the February-March period.

With respect to bank lending policies, Mr. Mayo remarked that three of the largest banks in his District with whom he had had contacts recently had volunteered the information that they were continuing to pursue very restrictive policies. In several major cities, they were denying credit to borrowers who would have been welcomed a year ago. Surprisingly, they were not being so restrictive in Detroit. At this point, the unwillingness to lend was more important than the availability of funds. Bankers now believed that the System had been right in urging them to be more prudent. Nevertheless, he did not subscribe to the view that, apart from taking further easing actions, the System should make it clear that it wanted banks to relax their lending policies.

2/19/75

-79-

Concerning the discount rate, he expected to recommend a cut of a half of a point at the regular meeting of the directors of the Chicago Bank 2 days hence. Like Mr. Morris, he believed that it would be desirable on occasion for the Board to table recommendations for changes, particularly when there was a chance that a change would be approved within a week or so; he did not believe that there was a danger of leaks from among the Chicago directors, who were constantly reminded of the importance of confidentiality. And when the Board of Governors turned down proposed changes, he did not immediately inform his directors of that action, so they would not be aware that the proposal had been tabled rather than disapproved.

Mr. Balles remarked that he also did not inform his directors when a proposed change had been disapproved.

Chairman Burns commented that members of the Board and the Presidents ought to review the procedures in question with a view to developing a uniform System practice.

Mr. MacLaury said he agreed that political pressures, which would be intensifying soon enough, could not be allowed to influence System policy. With respect to the longer-run targets, nothing had happened since the last meeting to suggest that the Committee should be prepared to accept a lower rate for

M₁ than it had then. Accordingly, he favored alternative A. The funds rate had declined too slowly over the past half year in large part because the Committee had tended to specify too narrow a range, and like Mr. Mayo, he would widen it; his preference was for a range of 4 to 6 per cent. He was not interested in achieving a reduction in the funds rate for its own sake--especially if, as the latest week's data suggested, growth in the monetary aggregates was picking up. Over the next month, he would use the full range for the funds rate only in the event that growth in the aggregates appeared to be falling outside the specified ranges. If the System provided the reserves, banks would increase their investments, but they were unlikely to expand loans. He agreed that it would be desirable to purchase longer-term securities in the process of providing reserves. Concerning the language of the directive, he personally did not attach much importance to the way in which the desired growth in the aggregates was described; as the discussion today demonstrated, the language of any of the proposed operational paragraphs often could be associated with any of the sets of specifications.

With regard to the discount rate, Mr. MacLaury remarked, the directors of the Minneapolis Bank would be happy to renew their recommendation for a cut of one-half of a point, their recent

2/19/75

-81-

recommendation having been turned down. He shared the concern about maintaining secrecy with respect to pending actions. One possibility, which he had not yet thought through, would be to establish a standard waiting period--of a week, perhaps--for the disposition of all proposed actions.

Mr. Francis remarked that for several months he had emphasized the special influences that had characterized the current downturn in activity. Since midyear, however, the Committee had permitted the aggregates to grow at such slow rates that demands for goods and services were bound to be adversely affected; no matter what the Committee now did to affect the aggregates in the short run, the policy actions taken over the past 6 or 8 months would continue to affect developments over the next quarter or two. The more important consideration now was the effect that current policy decisions would have on developments beyond the near term. The Committee could attempt to inject reserves at a pace that would stimulate rapid growth in the monetary aggregates for a time, with a view to compensating for the slow growth since mid-1974 and, perhaps, improving the economic situation somewhat in the short run, but that would increase the difficulties that lay further down the road.

Consequently, Mr. Francis said, he could not accept any of the alternatives presented by the staff. From this point on, he would attempt to move M_1 toward a growth path between 5 and 6 per cent, at an annual rate. He would note that under alternative D, the most conservative of the four alternatives, M_1 was indicated to grow on a quarterly average basis at annual rates of about 5 per cent from the first to the second quarter, 6.7 per cent from the second to the third quarter, and 5.8 per cent over the whole period from the first to the third quarter. Thus, even the most conservative of the alternatives bordered on the maximum rate of monetary growth that should be sought in 1975.

With regard to the discount rate, Mr. Francis commented that it ought to be moved down in accordance with declines in market interest rates. He hoped that when market rates turned up again, the discount rate would be moved up as readily as it had been moved down.

Mr. Bucher observed that he continued to favor a policy of deliberate but not precipitous ease. Over the past few months policy had been eased substantially in terms of interest rates; while he was disturbed by the weak performance of the aggregates, he believed that growth soon would pick up. The possible degree of fiscal stimulus remained a source of concern. He was concerned also about the possibility of an upturn in short-term

2/19/75

-83-

interest rates just before or at the start of the recovery in economic activity--with a possible effect on longer-term rates--and noted the blue book comment that under alternative A a sharp rise in rates probably would be necessary in late spring or in the summer.

Continuing, Mr. Bucher commented that he also continued to be concerned about public reactions to System policy and about public confidence in the System. The recent rise in the stock market was an encouraging sign of some revival in confidence. Investors with whom he had talked recently generally believed that the recovery would begin after midyear, and there was increasing confidence that inflation could be abated, at least, and that the rate of increase in prices would not immediately accelerate again and pose a major economic problem.

Mr. Bucher said he favored the specifications of alternative B. However, he preferred the language of alternative A, because he believed that "more rapid growth in the aggregates" clearly stated the appropriate objective. He agreed with the suggestion of some other Committee members that the Desk make greater purchases of coupon issues in the process of providing reserves.

2/19/75

-84-

Mr. Winn remarked that while he often had reservations about the relationships within the various sets of specifications presented to the Committee, he nevertheless thought that at times the failure of the Committee to achieve its objectives resulted from a tendency to adopt specifications that were inconsistent with the implied relationships; he became concerned, therefore, when the Committee began to modify specifications in a way that might make them internally inconsistent. Because growth in the aggregates had fallen far short of the rates that he would have preferred in this period, he favored alternative B. That was the course most consistent with the longer-term objectives that the Committee had set earlier. Like some others, he would widen the range for the Federal funds rate in order to increase the chances that shortfalls in growth of the aggregates, such as those witnessed in recent months, could be avoided.

Mr. Winn said he favored a reduction of a half of a point in the discount rate. However, there were differences of opinion among his directors; the bankers on the Board were reluctant to see the rate decline.

Mr. Sheehan left the meeting at the conclusion of Mr. Winn's remarks.

Mr. Coldwell commented that he would like to see M_1 grow without strong action by the Committee to achieve that objective;

that could occur if bank attitudes toward lending were changed. At the same time, however, he would not want to risk no growth in M_1 . Accordingly, he favored specifications between those of alternatives A and B, with a range of 5 to 6 per cent for the Federal funds rate and an instruction to the Desk to move the rate down promptly until growth in M_1 was resumed. For M_1 in the February-March period, he would specify a widened range of 6 to 9 per cent. He could accept some increase in the longer-term target for M_1 , but he would not want to see growth in a range as high as 6 to 8 per cent toward the end of the year. Concerning the language of the directive, he would alter the paragraph describing the Committee's general policy stance so as to give more emphasis to the objective of recovery in economic activity. Thus, he would say ". . . it is the policy of the Federal Open Market Committee to foster financial conditions aimed at halting the recession and stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments."

Chairman Burns remarked that Mr. Coldwell's objective might be served by reordering the clauses in the staff's draft so that the paragraph would read as follows: "In light of the foregoing developments, it is the policy of the Federal Open Market

Committee to foster financial conditions conducive to cushioning recessionary tendencies and stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments."

There was general agreement with the Chairman's suggestion.

Mr. Baughman observed that his recent conversations with bank loan officers and management people, as well as the latest statistics, suggested that at present banks could be characterized as quite reluctant lenders. In order to change that, the System would need to improve the liquidity position of the banks. With respect to discount rate policy, the directors of his Bank preferred to be followers rather than leaders in the current economic environment. They had gone along with invitations to be in the first wave of the last two reductions in the rate, but they remained quite concerned about the possibility of a re-invigoration of inflationary pressures later in the year. In addition, the views of some of them had been influenced by the fact that the economic situation in the Eleventh District was more favorable than that in the rest of the country. At the present time, it might be possible to condition the framework in which increases in the discount rate would be made in the future by establishing a closer link between that rate and market interest rates and by making that policy known to the public.

Continuing, Mr. Baughman said he was uncertain what was meant by some references that had been made to an accommodative policy. If that term was used to mean only that the System would provide all the reserves that would be demanded at a specified price, he did not think it added very much. As to the policy alternatives today, he favored alternative B. However, he felt that, given a little more time, growth in the aggregates might well begin to expand more rapidly, and he would not be inclined immediately to push the funds rate down. Nevertheless, it was necessary to achieve some expansion in total reserves in order to get the banks to ease their lending policies and to foster somewhat faster growth in the aggregates.

Chairman Burns observed that he would describe the nature of the cyclical movement under way as the downward phase of a long cycle. The severe recession in economic activity, although very costly in human terms, was serving a purpose: the rate of inflation was slowing down. Also, the very rapidity of the decline in activity was laying the basis for an early upturn, because it was attributable chiefly to a large shift to inventory liquidation from a rate of accumulation that had been bred by illusions associated with inflation. Corrective forces were now under way.

The Chairman remarked that it was clear from the discussion that most Committee members favored the language of alternative A and the specifications of either alternative B or alternative C. Noting that most members appeared to favor a Federal funds rate range of either 5-1/4 to 6-1/4 per cent or 5-1/2 to 6-1/2 per cent, he called for an informal poll of preferences between those two ranges.

A majority of the members indicated that they preferred a range of 5-1/4 to 6-1/4 per cent.

The Chairman then observed that he believed the specifications for the aggregates under alternative B would be acceptable to the members. He proposed that the Committee vote on a directive consisting of the staff's draft of the general paragraphs, with the change in the statement of the Committee's general policy objectives that had been agreed upon earlier, and alternative A for the operational paragraph. It would be understood that the directive would be interpreted in accordance with the following specifications. The longer-run target growth rates for M_1 , M_2 , and the bank credit proxy would be those shown in the blue book under alternative B.^{1/} The associated ranges of tolerance for growth rates in the February-March period would be 1/4 to

^{1/} These were as follows (annual rates):

	<u>June '74-</u> <u>June '75</u>	<u>Dec. '74-</u> <u>June '75</u>	<u>Dec. '74-</u> <u>Sept. '75</u>
M_1	3-3/4	4-1/2	6
M_2	6-3/4	7-1/2	8-1/2
Proxy	6	6-1/2	8

2/19/75

-89-

2-1/4 per cent for RPD's, 5-1/2 to 7-1/2 per cent for M_1 , and 6-1/2 to 8-1/2 per cent for M_2 . The range of tolerance for the weekly average Federal funds rate in the inter-meeting period would be 5-1/4 to 6-1/4 per cent.

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

The information reviewed at this meeting suggests that real output of goods and services is continuing to fall sharply in the current quarter. In January declines in industrial production and employment were large and widespread for the third consecutive month. The unemployment rate rose a full percentage point to 8.2 per cent. Average wholesale prices of industrial commodities, which were unchanged in December, rose moderately in January, and prices of farm and food products declined further. In recent months increases in average wage rates have moderated, although they have still been large.

The decline in the foreign exchange value of the dollar was arrested in early February by concerted central bank intervention and a sharp decline in European interest rates, but in recent days the dollar has declined somewhat. In December the U.S. foreign trade deficit increased, but it was smaller in the fourth quarter as a whole than in the third.

The narrowly defined money stock, after having grown at an annual rate of about 4-1/2 per cent over the fourth quarter of 1974, declined sharply in January. However, net inflows of consumer-type time and savings

deposits at banks and nonbank thrift institutions were large, and broader measures of the money stock continued to expand. Business demands for short-term credit have weakened in recent months, both at banks and in the commercial paper market, while demands in the long-term market have been exceptionally strong. Since mid-January short-term market interest rates have fallen substantially further, and yields on long-term securities also have declined. Federal Reserve discount rates were reduced from 7-1/4 to 6-3/4 per cent in early February.

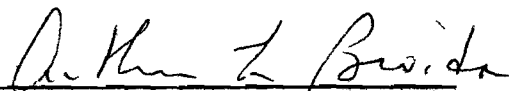
In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to cushioning recessionary tendencies and stimulating economic recovery, while resisting inflationary pressures and working toward equilibrium in the country's balance 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 more rapid growth in monetary aggregates over the months ahead than has occurred in recent months.

Secretary's note: The specifications agreed upon by the Committee are appended to this memorandum as Attachment D.

It was agreed that the next meeting of the Committee would be held on March 18, 1975, at 9:30 a.m.

Thereupon the meeting adjourned.


Secretary

ATTACHMENT A

February 10, 1975

TO: Federal Open Market Committee SUBJECT: Chairman Burns' meeting
with Presidents Klasen and
FROM: Arthur L. Broida Leutwiler

At a meeting of the Board of Governors on February 4, 1975, Chairman Burns reported briefly on conversations he had had in London on Saturday, February 1, with President Klasen of the German Federal Bank and President Leutwiler of the Swiss National Bank. For your information and records, a summary of his remarks is given below.

Chairman Burns noted that he had originally intended to be in England during the past weekend to attend the Anglo-American Conference at Ditchley. As the time approached he had considered canceling the trip because of the heavy volume of work at his desk. During the period January 27-29, however, he had been talking by telephone each day with Presidents Klasen and Leutwiler about the depreciation of the dollar in foreign exchange markets that was causing concern not only in this country but also abroad. A number of questions were clarified in those conversations, but there were some that could not be readily resolved by telephone, and it was agreed that a face-to-face discussion would be fruitful. Accordingly, after consultations with Governor Mitchell (the third member of the Subcommittee, Mr. Hayes, was absent), he decided to proceed with the trip to England, partly to attend the Ditchley conference, but mainly for the purpose of meeting with the two central bank Presidents.

The Chairman observed that he was accompanied to the meeting by Mr. Coombs. President Klasen was accompanied by Mr. Emminger; President Leutwiler came alone. The meeting was held on Saturday morning and lasted about 2-1/2 hours. The discussion was frank and friendly.

Among the conclusions reached was a negative one: no change would be made in the present policy of intervening only for the purpose of helping to maintain orderly exchange markets; in particular, no attempt would be made to peg exchange rates. In that connection, he (Chairman Burns) had even declined to discuss possible numerical targets for the levels of exchange rates in the short run.

The positive conclusions were as follows:

1. Henceforth, the three central banks would follow more concerted intervention policies than in the recent past, when at times they had operated somewhat at cross purposes. To assure coordination, there would be daily consultations among those responsible for market operations.

2. The three central banks would follow a more active intervention policy, operating on a larger scale than in the recent past. Operations would be undertaken only at times when the dollar was showing signs of weakness.

3. It was agreed that the three central banks would intervene forcefully on the following Monday (February 3) if the dollar showed weakness in the exchange markets.

4. On procedural matters, it was agreed that the group's conclusions would represent informal understandings and would not be reduced to writing, and that they would be subject to change on short notice. It was also agreed that no announcement of the meeting would be made, but that if questions were raised no effort would be made to evade them. In particular, it was understood that if inquiries were made of Chairman Burns, he would issue a brief statement. Such an inquiry was in fact received, and on Monday the Chairman issued the following statement:

"In my judgment, the dollar is basically a very strong currency. The Federal Reserve, together with other Central Banks, is intervening and will intervene, as needed, to maintain orderly exchange markets."

ATTACHMENT B

Henry C. Wallich
February 19, 1975

Notes on Basle Meeting on Monday, February 10, 1975

Considerable interest was shown in the outcome of Chairman Burns' meeting in London on Saturday, February 1, with Presidents Klasen and Leutwiler. In general, the ensuing intervention in exchange markets was well received, as evidence that the U.S. was taking a stronger interest in the defense of its currency. Questions were asked concerning the level to which the dollar rate for DMark and Swiss francs might be moved, what the scale of intervention might be, and how long the action might continue. The responses given by the German, Swiss and U.S. representatives were to the effect that the intention was to intervene more forcefully in pursuit of orderly markets but not of particular rates, and that no time period had been set. The U.S. representative in particular stressed that no pegging was involved, but only a more deliberate policy with respect to the dollar rate. They stressed also that, while the meeting had not taken place in Basle, it was in the nature of a reaffirmation of the agreement on exchange intervention arrived at in Basle in May 1974.

Varying views were expressed as to the potential effectiveness of the intervention. The discussion turned on whether or not the exchange market was in a "turnaround situation," in which substantial leverage could be exerted with the employment of limited funds. This

was thought to depend on factors such as interest rates, budgetary developments in the United States, and confidence. Some very muted suggestions for more broadly coordinated intervention and even a move toward a greater fixity of the rate structure were voiced. Some of this discussion reflects ongoing efforts among the EEC countries to limit the daily width of fluctuations among their currencies through intervention in the dollar. The EEC countries still appear to be in the process of sorting out a plan along these lines, after an initial effort to formulate a specific plan apparently had encountered misunderstandings. We are to be kept informed of the progress of these ideas, but the project technically is an EEC rather than a BIS matter.

February 19, 1975

Drafts of Domestic Policy Directive for Consideration by the
Federal Open Market Committee at its Meeting on February 19, 1975

GENERAL PARAGRAPHS

The information reviewed at this meeting suggests that real output of goods and services is continuing to fall sharply in the current quarter. In January declines in industrial production and employment were large and widespread for the third consecutive month. The unemployment rate rose a full percentage point to 8.2 per cent. Average wholesale prices of industrial commodities, which were unchanged in December, rose moderately in January, and prices of farm and food products declined further. In recent months increases in average wage rates have moderated, although they have still been large.

The decline in the foreign exchange value of the dollar was arrested in early February by concerted central bank intervention and a sharp decline in European interest rates, but in recent days the dollar has declined somewhat. In December the U.S. foreign trade deficit increased, but it was smaller in the fourth quarter as a whole than in the third.

The narrowly defined money stock, after having grown at an annual rate of about 4.5 per cent over the fourth quarter of 1974, declined sharply in January. However, net inflows of consumer-type time and savings deposits at banks and nonbank thrift institutions were large, and broader measures of the money stock continued to expand. Business demands for short-term credit have weakened in recent months, both at banks and in the commercial paper market, while demands in the long-term market have been exceptionally strong. Since mid-January short-term market interest rates have fallen substantially further, and yields on long-term securities also have declined. Federal Reserve discount rates were reduced from 7-1/4 to 6-3/4 per cent in early February.

In light of the foregoing developments, it is the policy of the Federal Open Market Committee, while resisting inflationary pressures and working toward equilibrium in the country's balance of payments, to foster financial conditions conducive to cushioning recessionary tendencies and stimulating economic recovery.

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 more rapid growth in monetary aggregates over the months ahead than has occurred in 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 somewhat more rapid growth in monetary aggregates over the months ahead than has occurred in recent months.

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 moderate growth in monetary aggregates over the months ahead.

Alternative D

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 D

February 19, 1975

Points for FOMC guidance to Manager in implementation of directive		Specifications (As agreed, 2/19/75)		
A.	<u>Longer-run targets (SAAR):</u>	June '74- <u>June '75</u>	Dec. 74- <u>June '75</u>	Dec. '74- <u>Sept. '75</u>
	M ₁	3-3/4%	4-1/2%	6%
	M ₂	6-3/4%	7-1/2%	8-1/2%
	Proxy	6%	6-1/2%	8%
B.	<u>Short-run operating constraints:</u>			
1.	Range of tolerance for RPD growth rate (February-March average):			1/4 to 2-1/4%
2.	Ranges of tolerance for monetary aggregates (February-March average):	M ₁	5-1/2 to 7-1/2%	
		M ₂	6-1/2 to 8-1/2%	
3.	Range of tolerance for Federal funds rate (daily average in statement weeks between meetings):			5-1/4 to 6-1/4%
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.			