MEMORANDUM OF DISCUSSION

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, November 17, 1970, at 9:30 a.m.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Daane
Mr. Francis
Mr. Heflin
Mr. Hickman
Mr. Maisel
Mr. Mitchell
Mr. Robertson
Mr. Sherrill
Mr. Swan

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

Messrs. Eastburn, Clay, and Coldwell, Presidents of the Federal Reserve Banks of Philadelphia, Kansas City, and Dallas, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Messrs. Kenyon and Molony, Assistant Secretaries
Mr. Hackley, General Counsel
Mr. Partee, Economist
Messrs. Axilrod, Craven, Gramley, Hersey, Hocter, Parthemos, Reynolds, and Solomon, Associate Economists
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Messrs. Bernard and Leonard, Assistant Secretaries, Office of the Secretary, Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors

Messrs. Wernick and Williams, Advisers, Division of Research and Statistics, Board of Governors
Mr. Keir, Associate Adviser, Division of Research and Statistics, Board of Governors
Mr. Wendel, Chief, Government Finance Section, Division of Research and Statistics, Board of Governors
Miss Ormsby, Special Assistant, Office of the Secretary, Board of Governors
Miss Eaton, Open Market Secretariat Assistant, Office of the Secretary, Board of Governors
Miss Orr, Secretary, Office of the Secretary, Board of Governors

Mr. Fossum, First Vice President, Federal Reserve Bank of Atlanta
Messrs. Link, Taylor, and Tow, Senior Vice Presidents, Federal Reserve Banks of New York, Atlanta, and Kansas City, respectively
Messrs. Scheld and Andersen, Vice Presidents, Federal Reserve Banks of Chicago and St. Louis, respectively
Messrs. Gustus and Kareken, Economic Advisers, Federal Reserve Banks of Philadelphia and Minneapolis, respectively
Mr. Friedman, Consultant, Federal Reserve Bank of Boston
Mr. Cooper, Manager, Securities and Acceptance Departments, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee held on October 20, 1970, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on October 20, 1970, 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 October 20 through November 11, 1970, and a supplemental report covering the period November 12 through 16, 1970. Copies of these reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Coombs said that since the last meeting of the Committee the London gold price had been pushed up by speculative demand to well over the $39.00 level, but it subsequently fell back by more than $2.00 as the Swiss Banking Commission took a decision to eliminate gold from the cash reserves of the Swiss commercial banks. He found it somewhat disappointing that the price had not fallen still further, since the Swiss commercial banks probably held at least $250 million of gold in their reserves at the moment. The prospect of so large an amount of gold being liquidated over the next year or so should have exerted more of a depressing effect on the market price. Unfortunately, speculative demand continued to be fed by a variety of official statements suggesting an impending confrontation between the United States and the Common Market not only on trade policy but also on the question of appropriate exchange parities.

On the exchange markets, Mr. Coombs continued, the dollar had remained at or close to the floor against most of the major European currencies, reflecting the continuing payments deficit of the United States together with the reduction by U.S. banks of their

Euro-dollar liabilities to London branches. At the last meeting of the Committee he had suggested that there was a fairly good chance that the resultant flows of dollars to the European central banks could be digested reasonably well over the rest of this calendar year. In particular, he had expressed the hope that British credit policy would remain firm and thereby provide a safe haven for some of the new dollar flows to the Euro-dollar market. As British interest rates had in fact held steady against the background of declining Euro-dollar rates, London had gained an interest arbitrage advantage which had helped pull in a substantial amount of hot money. Although inflation was now proceeding faster in the United Kingdom than in almost any other major country, the publication of good trade figures for October had enabled the Bank of England to pick up $150 million in the market yesterday. As the members knew, the British had paid down their swap debt to the System to $125 million.

Italy continued to provide another safe haven for short-term capital flows out of the Euro-dollar market, Mr. Coombs observed. He understood from Governor Carli that the Bank of Italy planned to keep credit tight enough to encourage a continuing shift of Euro-dollar funds into the Italian market. French debt to the International Monetary Fund was now more than fully covered by the growth in the dollar reserves of the Bank of France, but he still had had no hints that the French were planning to ask the Federal

Reserve to take over further dollar inflows. That situation might persist through the year end, but subsequent dollar flows to France might create operating problems for the U.S. authorities. Meanwhile, the German Federal Bank seemed resigned to the inevitability of heavy dollar receipts so long as money rates in Germany remained so much in excess of Euro-dollar levels. Today, however, the Federal Bank had cut its discount rate from 7 to 6-1/2 per cent and its Lombard rate from 9 to 8 per cent. That action apparently reflected a tapering off of the German boom, and it might well result over coming months in a shift of dollar flows into less accommodating hands than the Germans' had proved to be.

Mr. Coombs noted that the only financing problems encountered since the last meeting of the Committee had resulted from the further flows of dollars to the central banks of Belgium and the Netherlands. Federal Reserve swap debt to those two banks had been increased from \$455 million to \$550 million. After the System's \$300 million line with the Dutch was exhausted, the Treasury had sold \$30 million of gold and \$30 million of special drawing rights to the Netherlands Bank to absorb new dollar inflows. He continued to think that it should be possible to get by through the year end without encountering unduly serious financing problems, even if a further substantial runoff of U.S. bank liabilities to their London branches should occur.

However, Mr. Coombs observed, the new year probably would get off to a bad start because of heavy return flows to the

Euro-dollar market, involving most of the corporate funds repatriated at the end of this year. The effect of those return flows might be partly offset if the British made large seasonal reserve gains in the first quarter, as they had last year. As the year progressed, however, the future of the dollar would probably turn on whether or not the United States managed to achieve a reasonable degree of price stability. If it did so, he thought there was a reasonable likelihood that much of the balance of payments problem would solve itself, automatically rehabilitating the standing of the dollar internationally.

In that connection, Mr. Coombs noted that recent studies by Board staff members had pointed up the close relation between the rate of price advance in this country and the state of the U.S. trade balance. He was very much inclined to think that the authors' judgment--that the trade balance would recover if domestic inflation was contained--was correct. However, if the United States should lag behind Europe in its stabilization efforts, or do no better than keep pace with European inflation, it was all too likely that there would be a progressive saturation of European central bank willingness to take on additional dollars. That could produce a major confrontation between the United States and the Common Market countries, and would entail a great risk of massive speculation. It did not particularly matter to the exchange markets whether the outcome was a revaluation of the Common Market currencies as a group or a devaluation of the dollar; the possibility of either would offer large opportunities for profit and large risks of loss. One had only to recall that as much as $3 billion had moved into Germany over a three-day period as a result of speculation on a revaluation of the mark alone to realize that flows could easily reach $10 to $15 billion in speculation involving all of the Common Market currencies.

At the last meeting of the Committee, Mr. Coombs continued, he had noted the further risk that such a policy confrontation between the United States and the Common Market might very well lead to a call by the Common Market for the United States to make the adjustment in the form of a change in the gold price. There had been a number of contingency planning discussions among the Common Market countries on that point, and he now understood that the Swiss and Japanese authorities had also been drawn into the discussions. Perhaps even more ominous was the fact that the possibility of an adjustment on the U.S. side was now being mentioned in public statements by Common Market officials. For example, Governor Wormser of the Bank of France recently had something to say on the subject; and in last Thursday's edition of the Financial Times of London a review of a recent article by Dr. Ossola of the Bank of Italy attributed to him the statement that "the effect of a dollar devaluation on the price of gold is no longer a matter of great significance to the monetary system as a whole. A full discussion of the position of the dollar and gold is needed before any final decisions on exchange rate reforms can be taken." He suspected that more would be heard from the Europeans on that theme in the months to come.

Mr. Coombs said that quite aside from the System's general concern over such a policy confrontation in 1971, it had a very special concern--that of making sure it could extricate itself from possibly massive drawings on the swap lines during the course of the year. In that connection, the Committee would recall that in July 1968 there had been an exchange of letters between the Chairman of the Board and the Secretary of the Treasury designed to assure the Federal Reserve that the Treasury would supply reserve assets as needed to settle any swap debt incurred by the System that could not be settled otherwise. In view of the situation that might be emerging, he thought it would be highly useful to verify where the present Treasury team stood on that matter. Secondly, and perhaps even more important, he thought the Committee should seek before long a clearer understanding of just how far the Administration was prepared to go in defending the dollar on the exchange markets. If the Administration planned to go all out in that area, he thought the System could afford to assume fairly big risks in terms of foreign currency debt in order to give domestic stabilization measures a full opportunity to work their way through. If, on the other hand, there was any thought of allowing a balance of payments deficit to force a showdown between the United States and the

Common Market countries, he could see a possibility that the System might eventually find itself saddled with very heavy foreign currency liabilities that would have served no useful purpose. In effect, the swap arrangements were designed to deal with a situation in which both parties were cooperating to defend the rate between two fixed parities. If the United States were to drift into a political bargaining encounter over the issue of whether one parity was to be revalued or the other devalued, the very rationale of central bank swap operations would be called in question.

Mr. Mitchell asked whether central bankers of the Common Market countries appeared to be concerned about the risk that a recession in the United States might lead to a recession in Europe.

Mr. Coombs responded that they did not seem to consider that to be a major risk at the moment. Their main concern was whether the United States would develop effective policies to arrest the inflation which they thought was eroding the value of their reserves and creating other problems.

Chairman Burns noted that production indexes for a number of European countries had flattened out recently, and asked whether the central bankers in question appeared to be expecting a recession in Europe, independently of their views regarding the United States.

Mr. Coombs expressed the view that while the Europeans might be expecting some leveling off in their economies they believed the backlogs of demand were sufficient to make significant declines in activity unlikely.

Mr. Hickman asked whether the Europeans were concerned about the present mix of stabilization policies in the United States. In particular, he wondered whether they were focusing on the fact that a different mix--involving less monetary ease and less fiscal restraint--might be associated with smaller dollar outflows from the United States.

Mr. Coombs said he had not heard much discussion of the fiscal-monetary policy mix. The Europeans seemed to be placing the greatest emphasis on the need for an incomes policy in the United States. In their judgment the outcome with respect to an incomes policy would determine how the dollar fared over the course of the next year or two.

In reply to another question by Mr. Mitchell, Mr. Coombs said he still held the view he had expressed at the last meeting that a return flow of Euro-dollars from U.S. banks on the order of $2 billion through the year end might be accommodated without undue difficulty. However, he would emphasize the distinction he had drawn between the prospects for the rest of this year and those of next year; as he had indicated, the latter appeared ominous.

By unanimous vote, the System open market transactions in foreign currencies during the period October 20 through November 16, 1970, were approved, ratified, and confirmed.

The Chairman then invited Messrs. Daane and Brimmer to report on the foreign meetings they had attended recently.

Mr. Daane said he would touch on only the highlights of the Basle meeting on November 8, which he had attended along with Messrs. Hayes and Coombs. First, it was evident that some sharp differences of view had developed among the Common Market countries in their effort to move down the road of economic and monetary integration following the publication of the Werner report in October. At one extreme, the French were unwilling to go along with any plan that might involve the eventual loss of some of their autonomy. At the other extreme, the Germans were not likely to agree to any tinkering in the monetary area unless it was coupled with efforts toward a harmonization of the member countries' over-all monetary and fiscal policies. Thus, it appeared that the Common Market's time table for beginning to move toward monetary integration had been set back a bit.

Secondly, Mr. Daane continued, considerable concern had been expressed at the Basle meeting--and also at the meeting of the Working Party 3 in Paris on October 20 which he had attended--about the reflows of Euro-dollars, which were viewed as interfering with the monetary policies being pursued in Europe. The concern was most strongly expressed by the Swiss and the Germans, but it was shared by others. He agreed in general with Mr. Coombs' assessment that the magnitude of the problem depended on the size and direction of the reflows, although he was not quite as optimistic as Mr. Coombs about the readiness of countries to absorb dollar reflows during the balance of 1970.

Finally, Mr. Daane said, in the go-round at Basle he had noted with interest that Governor O'Brien was quite optimistic about the short-run prospects for sterling in exchange markets, but at the same time quite pessimistic regarding Britain's fight against inflation. Governor O'Brien viewed the government's program as somewhat expansionary on balance, and concluded that the country had to accept either more inflation or greater unemployment. The comments of President Klasen of the German Federal Bank--to the effect that the German boom had peaked out and that German interest rates would have to come down in the next few weeks--foreshadowed the discount rate reduction that Bank had made today. President Zijlstra of the Netherlands Bank said that effective steps would be taken to deal with inflation in the Netherland, including a wage freeze.

Mr. Daane then noted that Mr. Hayes might have some observations to add.

Mr. Hayes said he had been struck by the almost universal expressions of concern with the wage and price problem. Mr. Zijlstra, for example, spoke of an increase of wages this year in the Netherlands of about 12 per cent, as compared with a 5 per cent gain in productivity. It was widely felt that fiscal and monetary policies in most major industrial countries would have to be supplemented by some kind of incomes policy. He might also note that there had been some discussion of the sterling agreements. Governor O'Brien had indicated that he was proceeding to talk with members of the overseas sterling area about the possibility of extending those agreements for another two years when their original three-year term expired.

Mr. Brimmer remarked that the meeting of the Economic Policy Committee of the OECD which he had attended yesterday--and which was still going on today--also was concerned mainly with the subject of inflation. In accordance with instructions given at the preceding EPC meeting, the Secretary General had asked the OECD Secretariat to prepare a paper on the problem of inflation. That paper--along with a note by the Secretary General--served as a focus of the discussion yesterday and today. The main theme of the Secretariat's paper was that in the mid-1960's a secular shift toward inflation had developed in the member countries of the OECD, and that present social and institutional arrangements made it impossible to fight inflation successfully with the conventional tools of monetary and fiscal policy. Accordingly, some form of incomes policy was cautiously advocated. More fundamentally, the paper argued that countries would have to accept a higher level of unemployment and a greater margin of unused resources if inflation was to be checked. The paper suffered from a number of technical defects, but the speakers at yesterday's session subscribed in general to its main theme. The Secretary General planned to forward specific recommendations to member governments, and it was anticipated that those governments would respond. Mr. Brimmer said he would have a summary of the discussion distributed to the members of the Committee shortly.

Mr. Brimmer noted that he had heard no discussion of a subject mentioned earlier by Mr. Mitchell--the possibility that a recession in the United States would lead to a recession in European countries. The persistence of upward pressures on wages and prices was viewed as the basic problem. Some distress was expressed at the meeting about developments in the United Kingdom, and there were suggestions that continued large deficits in the U. S. balance of payments might very well obstruct the growth and development of SDR's.

The Chairman then asked Mr. Coombs for his recommendations.

Mr. Coombs reported that four System drawings on the swap line with the National Bank of Belgium, totaling $60 million, would mature for the first time in the period from December 15 to December 23. He thought it was not very likely that the flow of funds would be such as to enable the System to repay those drawings at maturity, and he therefore recommended their renewal for further three-month periods.

Renewal of the four System drawings on the National Bank of Belgium was noted without objection.

Mr. Coombs then reported that nine of the System's swap arrangements--all of the arrangements except those with the central banks of Canada and the Common Market countries--would mature on December 2, 1970. He recommended renewal of those nine arrangements for further periods of one year.

By unanimous vote, renewal for further periods of one year of the following swap arrangements, having the indicated amounts and maturity dates, was approved:

Foreign bank	Amount of arrangement (millions of dollars)	Maturity of latest authorized renewal
Austrian National Bank	200	December 2, 1970
National Bank of Denmark	200	December 2, 1970
Bank of England	2,000	December 2, 1970
Bank of Japan	1,000	December 2, 1970
Bank of Mexico	130	December 2, 1970
Bank of Norway	200	December 2, 1970
Bank of Sweden	250	December 2, 1970
Swiss National Bank	600	December 2, 1970
Bank for International Settlements:		
Dollars against Swiss francs	600	December 2, 1970
Dollars against authorized European currencies other than Swiss francs	1,000	December 2, 1970

Mr. Coombs noted that the System's remaining swap lines, with Canada and the Common Market countries, would mature at various dates from December 16 through December 30. He had already had some intimations that the Common Market central banks might raise the question of whether the revaluation guarantee in the swap agreements should be dropped, on the grounds that U.S. pressure for revaluation of certain currencies removed such revaluations from the category of "remote contingency" contemplated by the language of the arrangement. He thought the Federal Reserve should resist any such proposals, and he was hopeful the Europeans would back away from them. Question might also be raised as to whether all swap drawings should not be made at par, on the grounds that some of the System's partners were losing money under the present procedure. He thought that any losses they had suffered were in fact incurred in connection with Treasury drawings on the IMF, so that the problem concerned the Treasury rather than the System. If such questions were raised he would distribute a memorandum on the matter to the Committee before the next meeting.

Mr. Brimmer recalled that in his earlier statement Mr. Coombs had put forward two suggestions. Specifically, he had suggested that it would be useful to determine (1) whether the Treasury was still prepared to supply reserve assets as needed to settle System swap debts that could not be settled otherwise, and (2) how far the Administration was prepared to go in defending the dollar on the exchange markets.

After discussion it was agreed that the best procedure for pursuing the matters in question would be for Chairman Burns to discuss them informally with senior officials of the Treasury.

The Chairman then called for the staff economic and financial reports, supplementing the written reports that had been distributed prior to the meeting, copies of which have been placed in the files of the Committee. At this meeting the staff reports were in the form of a visual-auditory presentation and copies of the charts and tables have been placed in the files of the Committee.

Mr. Partee made the following introductory statement:

Incoming economic information over the past few months has been more bearish than the staff had anticipated. We had been looking for an economic upturn beginning this past summer and extending into 1971. While we still expect a recovery to be evident soon, the recent performance of the economy has led us to question how strong the recovery in 1971 is likely to be.

Obviously, making a projection does not in itself provide an answer to this question. But it does require us to think through systematically the potential sources of strength and weakness in the economy, which should help provide insight into the future.

As the point of departure in our projection, we have assumed continuation of a 5 per cent growth rate of the money supply--the Committee's target over the last several meetings. We believe this would imply bank credit growth at around an 8 per cent rate during 1971. There is, however, a great deal of uncertainty as to the amount of bank credit expansion consistent with any given growth rate of the money supply.

For fiscal policy, we have assumed a rise in Federal expenditures next year consistent with total budget outlays of $226 billion in fiscal 1972, compared with an expected level of $211 billion in the current fiscal year. This expenditure projection allows for an increase in Federal pay scales, a rise in social security benefits, and a continuation of ongoing Federal programs. It does not include any new initiatives or program cuts that might come along. As for tax rates, we are not projecting any changes other than those already legislated or recommended by the Administration--the details of which have been presented in the green book.[1/]

These fiscal policy assumptions imply a rise in Federal expenditures, as recorded in the national income accounts, in the first quarter of 1971. This reflects a Federal pay raise and a somewhat larger increase in social security benefits than is provided for in the House version of the social security bill. After the first quarter, expenditures would grow rather slowly over the remainder of 1971.

With social security tax rates also scheduled to rise in the first quarter of 1971, the path of Federal receipts would roughly parallel that of expenditures. The annual rate of deficit--as measured in the national income accounts--would thus stay in the general range of $14 to $15 billion reached this past summer.

A deficit of this size would help to sustain private disposable income. But it would reflect no more than the shortfall of revenues attributable to the slow pace of economic activity. On a high employment basis, our fiscal policy assumptions imply a movement of the budget to a modest surplus in the current quarter, with a further gradual increase in the surplus indicated over the course of calendar 1971.

To work out a quarterly GNP pattern, we also had to adopt assumptions about the auto strike. We assumed--fortunately, as it turns out--an ending of the GM strike at about midmonth.

I should also note that, as a means of permitting concentration on the important underlying factors shaping the course of the economy, we have made no attempt to allow for a steel strike, or a buildup of steel inventories in anticipation of a strike, next year. This would affect the pattern, though probably not the total, of GNP expansion during the year.

Mr. Gramley reported on recent developments as follows:

Major indicators of economic performance have been behaving recently in ways that are somewhat unusual by past cyclical standards. Real GNP has increased slightly

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

in each of the past two quarters, following a decline in the first 3 months of the year. But the turnaround in real output has been very small and quite narrowly based. Part of the rise has been due to a leveling off in inventory investment, following an earlier decline. And a notable contribution has come from construction outlays--especially residential building, which turned up last quarter in response to an increased availability of funds.

In other sectors, there are signs of continuing weakness. Even after allowance for the auto strike, industrial production has dropped appreciably further in recent months. The decline in October was another 2-1/4 per cent. With intensive efforts under way to cut costs, nonagricultural employment has declined, while unemployment has risen. These are not typical patterns for an economy in process of cyclical recovery, as the turnaround in real GNP might suggest.

The substantial weakness in industrial output stems principally from two major areas of durable goods production. Output of business equipment has been falling since late last year. The data for October--which have just become available--indicate that the decline from the peak now exceeds 10 per cent. This drop is in striking contrast to the continuing gradual increase in dollar expenditures for business fixed investment in the GNP accounts--which has reflected rising prices.

A second source of weakness has come from further declines in production for defense. Output of defense equipment is now about one-third below its peak of a little more than two years ago. Defense equipment has a smaller weight in the over-all index, however, than does business equipment.

Rising production and employment in these two sectors were major sources of excess demand and inflationary pressures in the middle years of the 1960's. At present, both sectors are undergoing significant downward adjustments.

Production declines in capital equipment and defense products have been accompanied by increases in the ratio of inventories to unfilled orders in both industries. In 1965, the ratio of inventories to unfilled orders began to rise for defense products; for capital equipment, the rise began in mid-1966. In those earlier years, the increase in this ratio occurred in the context of a buildup of new orders for these goods. Producers then were gearing up for higher levels of output. More recently, however, the sharp further rise in the ratio for capital equipment industries has largely reflected steep declines in the backlog of unfilled orders. In defense products, the upward drift in the ratio since early 1969 has occurred even though inventories, production, and unfilled orders all have declined significantly. These developments imply imbalances that will lead to further inventory adjustments unless orders and production turn up again.

Outside the auto industry, the prospects for a near-term pickup in durable goods production seem rather dim. Total new orders for manufacturers' durables, after seeming to turn up last spring, began to decline again after midyear. Part of the falloff in recent months was related to the GM strike. But there has been no improvement in orders for capital equipment, following the decline earlier this year--suggesting that business fixed investment will not contribute to recovery for some time to come. Private surveys of anticipated plant and equipment expenditures support this view. The McGraw-Hill survey shows a growth of only 2 per cent in dollar expenditures for plant and equipment planned for 1971, which implies a further decline in real terms.

A number of influences have worked to turn the tide of new capital investment, including the behavior of corporate profits. Corporate profits plus the inventory valuation adjustment as a share of income originating in nonfinancial corporations began to decline in late 1965, and with wage and salary payments rising rapidly, the decline accelerated over the past two years. The profit share is now at the lowest level of the post-war period. Although businessmen were slow in responding, the point was eventually reached at which realized rates of return on capital could no longer be ignored in business investment decisions.

For some time, the upward trend of interest rates was also brushed aside because of rising labor costs and inflationary expectations. Thus far, corporate bond rates have declined only marginally from the historic peaks of last spring. Interest rates may be affecting spending plans much more heavily now than earlier, given current and expected rates of return on capital.

Recently, the weakness in business investment spending has been offset by strength in housing. Starts have risen briskly since April, in response to the increased availability of mortgage credit as well as special Government support programs.

This prompt response of housing starts to the increased credit supply is attributable to the growing backlogs of demand for shelter. The vacancy rate for rental units has declined by about one-third since 1965.

Backlogs of demand do not imply, however, that continuing improvements in mortgage credit availability will assure an unlimited volume of construction outlays. We are hearing numerous reports of consumer resistance to the high costs of housing--including high mortgage rates as well as rising construction costs.

In the past year or so, there has been a sharp decline in the median price of new single-family homes sold, even though construction costs have risen steeply. Changing attitudes of buyers, as well as Federal programs to subsidize low cost housing, may be responsible for this decline. Consumers may have reacted to the cost situation by shifting their demands to smaller homes.

These changes in consumer behavior will have important implications for the longer-run strength of housing expenditures. Nonetheless, the near-term prospects seem quite good for a continued rise in starts and construction.

For State and local government construction, the outlook is also favorable. Historically, these outlays have displayed a strong growth trend--a trend interrupted in 1969 and 1970.

While these outlays have perked up recently, they are still below their longer-run trend. Intensive demand pressures in this sector have not abated and expenditures could rise appreciably further if adequate financial resources are available.

There is good reason to believe that continued growth in the nominal money stock at a 5 per cent rate, as our projection assumes, would provide for further gains in construction outlays--the type of spending most sensitive to supplies of money and credit. But the over-all degree of stimulus to be achieved by a 5 per cent monetary growth rate will be minimal unless the rate of price increase subsides. In real terms--that is, deflated by the consumer price level--the money stock has shown little net change this year. If prices were to rise at about a 3-1/2 per cent rate through 1971, a 5 per cent growth rate of nominal money would imply only a 1-1/2 per cent increase in the real money stock.

The rate of price increase also affects significantly the trend of income velocity--that is, the ratio of GNP to the nominal money stock. This year income velocity has leveled out and interest rates have declined, especially on short-term securities. If our expectations of some real growth in GNP and further price increases next year are realized, income velocity will trend upward once again, and transactions demand for money might more than absorb a 5 per cent rise in the money stock.

Past experience suggests that when income velocity rises slowly short-term interest rates generally remain relatively stable. Hence, the range of interest rates on 3-month Treasury bills consistent with our money supply assumption would appear to be a band around 5-1/2 per cent--that is, near recent levels. We could experience an appreciable decline in long-term rates, however, even if short-term rates remain unchanged, since the current yield curve is unusually steep. Pressures on the bond markets should ease as corporations largely complete balance sheet restructuring, require less external funds, and obtain more bank financing. The Aaa corporate new issue rate might perhaps fall to around 7-1/2 per cent by midyear and drift lower as the year progresses. Such a decline in the bond rate, however, would be unlikely to stimulate investment outlays significantly in the present climate of weak corporate profits and subsidence of inflationary price expectations.

These projected interest rate levels would permit commercial banks to bid freely for time deposits. Nonetheless, we would expect the growth of time deposits to decline from the high rates of the latter half of this year. Banks are already evidencing less interest in attracting CD's, as their liquidity positions have improved and loan demands have weakened. We would expect this reduced interest in attracting CD's to continue. Consumer-type time deposit inflows will likely provide substantial funds, although the rate of growth might edge down from the recent unusually high pace.

The rate of bank credit expansion, adjusted for loan transfers between banks and their affiliates, which seems consistent with these deposit inflows is approximately 8 per cent next year. This assumes a further reduction in nondeposit sources of funds in 1971.

With bank credit expansion at an 8 per cent rate, and loan demands projected to be relatively weak, we would expect banks to relax further their lending policies next year, to demonstrate more interest in term loans, and to add appreciably to their holdings of municipal securities and mortgages.

Mr. Wernick made the following comments on the GNP projections:

Our appraisal of developments in key sectors of the economy suggests that the recovery in GNP growth we can expect for 1971 is very moderate--given our policy assumptions. The bulge in GNP projected for the first quarter of next year reflects a catch-up in consumer expenditures for autos which have been severely depressed by the strike. By the second quarter, however, this stimulus should be largely behind us, and GNP growth is expected to recede to about the $14 billion range, roughly the same as in the third quarter of this year. By the last half of 1971 quarterly gains in GNP could pick up somewhat to the $16 to $17 billion range.

A large part of these increases in current dollar GNP will continue to reflect rising prices. In real terms, the projected rise in GNP is small. Real growth from the third quarter of 1970 to the second quarter of 1971 is projected at an average annual rate of about 2 per cent. In the last half of next year, if current dollar increases in GNP strengthen as expected, growth in real GNP would pick up to an annual rate of about 3 per cent. These projected real growth rates are well below our long-run potential.

We expect residential construction expenditures to make a strong recovery in 1971 to an annual rate of about $39 billion by the fourth quarter. The sharp pickup in housing starts already in train has only begun to be reflected in expenditures. Starts are expected to continue rising throughout next year, reaching over 1.8 million units by the fourth quarter.

A relatively bullish housing outlook seems reasonably well assured in 1971 by the sharp increase in mortgage credit availability now taking place and in prospect. Inflows into nonbank thrift institutions reached about a 10 per cent annual growth rate last quarter and should be sustained at only a little lower rate during 1971 by continued preferences of individuals for safety and liquidity in financial asset holdings. Expanded Federal programs will also play a supporting role in the housing market next year.

As noted earlier, we are counting on larger State and local purchases to provide important support to aggregate demand in the coming year. The average quarterly increase in total purchases is expected to rise to about $4 billion in the latter half of 1971.

A significant part of the rise in total purchases should occur in State and local construction expenditures--with municipal bond rates projected to decline because of heavy sustained buying of such securities by banks and a lessening of pressures in long-term credit markets generally. Other purchases will also move up, supported by higher tax revenues and increased Federal grants-in-aid.

In the Federal sector, purchases of goods and services are not expected to add much to total demands in 1971, although the decline in defense expenditures may come to an end about midyear, with the possibility of some subsequent rise. Non-defense purchases are expected to continue rising moderately over the course of next year.

Other NIA expenditures, which include grants-in-aid, social security benefits, and transfer payments, bulged in the second quarter of 1970, when social security payments increased and a Federal pay raise occurred that was retroactive to the first of the year. These expenditures will be increased early in 1971 by higher social security benefit payments, but thereafter are projected to follow a moderate growth trend.

A major source of weakness in the coming year stems from the lacklustre prospects for business fixed investment. With profits depressed, external funds still costly, capacity utilization rates low, and sales expectations weakening, we expect further postponements and cancellations of spending--especially for short lead-time items.

Our projection calls for capital spending to decline through mid-1971, and for the dollar volume of outlays during the year as a whole to be 2 per cent below 1970. In real terms, spending is expected to be down substantially more, since prices of capital goods are still moving up. Outlays in manufacturing are projected to decline sharply, but total expenditures will be sustained by large planned outlays of electric utilities and in communications.

Despite the lower rate of investment, the rate of capacity use in manufacturing is not likely to improve, since capacity is expected to grow at about the same rate as production. Our best estimate is that the rate of utilization may level out at about 73 per cent in the second half of next year.

There does not appear to be much prospect that a sharp upsurge in consumer expenditures serving to improve sales expectations in the business community will take place. Consumers remain pessimistic--and we expect rising prices, unemployment, and sluggish income growth to continue to dampen consumer spending in the year ahead.

Some rebound in consumer purchases is probable in the first quarter of 1971--when auto sales recover from strike-depressed levels. Thereafter, we expect the rate of auto sales to slow and total consumer outlays to show only moderate further gains. The increases in consumer outlays projected, moreover, assume that the personal saving rate will decline, as it usually does in a period of slow growth in disposable income.

Our projections of final sales also reflect the erratic movement of auto sales in the first half of the year. Thereafter, final sales should begin to rise somewhat more strongly in response to expected strength in residential construction and State and local outlays, and some improvement in business capital spending.

With inventories in many lines of durable goods still high relative to sales and unfilled orders, we foresee little rise in the rate of inventory investment over the course of next year. The relatively mild increase projected would be in marked contrast to developments in earlier postwar cycles, when sharp turnarounds in inventory accumulation helped fuel vigorous recoveries in industrial production and incomes.

Let us turn now to the implications of the projected slow growth of real output for resource utilization. Demand for labor has weakened appreciably this year--employment began to decline last spring and has continued downward in the current half year. By early 1971, we expect the employment totals to begin showing a moderate uptrend. Most of the projected increase is expected to be in services, trade, and State and local governments; manufacturing employment would show no growth, and could decline somewhat further.

In the context of weak labor demands, labor force growth has already eased appreciably and will continue to be dampened next year. However, further reductions in the Armed Forces and a large increase in the number of young adults of working age should result in a growth of the civilian labor force that is well above employment gains. Consequently, we expect unemployment to be rising throughout the year--averaging above a 6 per cent rate during the first half of 1971 and above 6-1/2 per cent in the second. Indeed, if productivity gains were to continue at the recent pace, our real GNP projection would imply an even weaker employment picture.

Easier labor markets this year have been accompanied by a tapering off in year-over-year increases in average hourly earnings in some sectors. In manufacturing, the slower increase has mainly reflected reduced premium pay and a shift in the distribution of employment away from the higher-wage durable good industries. Hourly earnings increases in construction, by contrast, accelerated sharply in 1969 and in the third quarter were still running about 10 per cent above a year earlier.

In less unionized industries, such as wholesale and retail trade, the slower rate of wage increases has probably reflected a slackening demand for workers.

For the private nonfarm sector as a whole, increases in hourly earnings in the past two quarters have averaged about 6 per cent above a year earlier; last year at this time, the year-to-year gain was about 7 per cent.

A feature of the GM and other recent labor contract settlements has been a relatively large wage rate increase in the first year of the contract, reflecting compensation for past increases in the cost of living. In the new GM contract, a large part of the 12.5 per cent first-year wage increase is due to past cost of living adjustments.

In the second and third years, the contract provides for productivity adjustments and other fringe benefits which cost out at slightly above 5 per cent per year. If the cost of living were stable over the life of the contract the average yearly increase in wages and benefits would be about 7.7 per cent.

The total cost of the contract in the second and third years, however, will depend on changes in the cost of living. If prices were to rise about 3 per cent per year, the average annual cost of the 3-year contract would be 9.4 per cent.

In union bargaining next year, efforts to recoup earnings lost through past price increases seem certain to continue--with the GM contract a likely pattern-setter. Consequently, we expect increases in average hourly earnings in the nonfarm economy next year to continue to be large and to edge down only slightly further.

Productivity has increased significantly in the past two quarters, as employers have trimmed work forces in response to rising costs and declining profit margins. Further moderate increases are expected in 1971, but gains will be more difficult to obtain because the benefits obtained from reductions in excess labor have already largely been achieved.

For the year as a whole, the rise in unit labor costs should be slowed somewhat by larger gains in productivity and the edging down in the rise in average hourly earnings. But the projected increase of 3-1/2 per cent in unit labor costs during 1971 is still very high.

In the past, when the unemployment rate rose to 6 per cent or more, as in 1958 and 1961, the rate of increase in the GNP deflator moderated substantially, generally to 2 per cent or less. But wage demands continue to be larger and more pervasive than at any time since World War II, mainly because consumer prices have risen rapidly over a sustained period. Recent large wage settlements imply continuing strong upward pressures on costs and prices.

We should therefore expect increases in the GNP deflator to remain historically high in relation to the unemployment rate. But we do expect a gradual easing in inflation, with the rate of increase in the GNP price deflator slowing to about a 3-1/4 per cent annual rate by late 1971.

Mr. Hersey then presented an analysis of the balance of payments as follows:

Last June, we concluded the international part of the chart show by noting that world demand for metals might have begun to be overtaken this year by growth of supply. We have ample confirmation now of that surmise, and evidence to broaden it beyond metals. European inventory demand for materials has fallen off markedly since last spring. One result has been a downturn in U.S. exports of materials, including steel and other semi-finished products. (This group comprises roughly 30 per cent of total exports.) Meanwhile, U.S. exports of machinery (a slightly smaller group in recent years) have continued to rise, and because export orders were still rising during the past summer and order backlogs are sizable, we expect the rise to go on into the first half of next year, at least in terms of dollar value.

The turn in the demand-and-supply situation for materials has been associated with a perceptible dip in total European industrial production since April. A leveling off, if not a decline, has appeared in every branch of industry, owing partly to shortages of qualified labor in some countries, but more generally to a slowing of business demand for investment in inventories and in fixed assets. In Germany, industrial production declined in September again. On the other hand, in both Germany and Britain retail sales in real terms have continued to increase--which is not surprising considering the sharp increase in wages in both countries. With this underlying strength of demand in mind, we are projecting a renewed rise in European industrial production into 1971, but at levels a little lower than those that were thought likely by a group of national experts who met with the Secretariat of the Organization for Economic Cooperation and Development last month. The projected fourth-quarter-to-fourth-quarter rise is 6 per cent.

The existing large backlog of orders for capital goods in Germany seems likely to ward off any absolute drop in output in this sector in the next few months. But it is clear that excess demand has been disappearing. New domestic orders of the capital goods industries in September, if adjusted for price inflation, were 7 or 8 per cent lower than a year earlier, though in current value they were 1 per cent higher.

While demand conditions in Europe, Japan, and Canada have a major part in determining our exports, conditions here influence our imports. In the generally inflationary period since 1964, imports of industrial materials and of foods have each increased somewhat more than 50 per cent in value, or about 8 per cent a year. But imports of finished manufactures, even without including autos from Canada, have tripled in value, with increases averaging over 20 per cent a year. Even between 1966 and 1967 they increased 8 per cent. At that time imports of materials dipped significantly. No such drop in the value of imports of materials has occurred during the present mini-recession, partly because unit values have continued to rise. As an example of other forces at work: with supply conditions easing abroad, our weak competitive position in steel has brought a new rise in steel imports since midyear. The slow expansion in domestic demand that we are considering today should hold down growth of U.S. imports in 1971. We should bear in mind, however, that the econometric equations on which these projections are based badly underestimated the imports of the past year.

Even with a very moderate increase in imports, we cannot expect much further improvement in the trade surplus next year, in the light of the less buoyant demand conditions abroad for our exports. In the next several months, a new wave of commercial aircraft exports is counted on to raise our trade surplus a little, but thereafter the trend in imports--which will be picking up--is likely to dominate. In contrast to the prospective leveling off in goods, the balance on services is projected as improving throughout 1971. Some of its rise in the latter part of next year comes from declining U.S. military expenditures abroad and rising military sales.

The main factor in raising the balance on services will be the divergence between the movements of U.S. receipts of investment income, principally from U.S. direct investments abroad, and U.S. payments of interest, principally on Euro-dollar borrowings and on the Treasury bills and time deposits in which foreign central banks' dollar reserves are mainly invested. The decline in interest rates brings U.S. payments down much more than U.S. receipts, while dividends and branch profits from U.S. direct investments are expected to rise. Thus, as previously indicated, net receipts on the investment income accounts should increase substantially between 1970 and 1971, perhaps by three-quarters of a billion dollars.

Summing up these projections, we expect net exports of goods and services to rise further to about $6 billion next year. This would be well short of the $8-1/2 billion record reached in 1964, but well above the $2 billion of 1969.

For the private capital accounts, the outlook is mixed. Among the more favorable elements, foreign buying of U.S. stocks resumed strongly in the third quarter. For the year 1971 we project purchases at a lower rate, but still exceeding 1970's net total by a half billion dollars or so.

Capital flows connected with U.S. direct investment abroad are projected to increase. A survey made in June indicated plans for an 18 per cent rise in plant and equipment expenditures by the foreign affiliates of U.S. corporations. Much of the increase, which could turn out less than that, would be financed by internal funds of the affiliates or by their borrowings abroad, but U.S. corporations, it is estimated, would increase their gross capital outflow by about half a billion. Under the Office of Foreign Direct Investment program, U.S. corporate borrowing from foreign sources holds down the net outflow. Taking into account all changes in U.S. corporate foreign assets and liabilities, an inter-agency group has projected a half-billion increase in net outflow of U.S. corporate capital--even if the present OFDI program is not relaxed.

The same group projected little change from this year's moderate net outflow on account of U.S. bank lending to foreigners. This may be overly optimistic, in view of the available leeway under the voluntary foreign credit restraint program and the prospect of greater availability of U.S. bank credit in general. However, U.S. banks have been expanding their lending through branches abroad, and the repayment of head office liabilities to branches leaves the branches with more funds to lend abroad.

The continuing repayments of Euro-dollar borrowings have recently brought the published Wednesday series below its May 1969 average. This corresponds to the fact that several banks by now have given up some parts of their reserve-free bases. Under current and prospective conditions there is no reason to suppose that repayments will not continue further.

The reason why repayments are continuing is obvious: though the cost of Euro-dollars is declining, it is not declining enough to catch up with falling rates on banks' alternative sources of funds in the United States. A major influence holding back the decline in Euro-dollar rates is the tightness of money in Germany. If we are right in supposing that Europe is not on the edge of a general recession and that concern about price inflation will continue to be very influential on German monetary policy, we cannot expect a sharp easing there. Today, as you have heard, the discount rate of the German Federal Bank has been reduced from 7 to 6-1/2 per cent.

The current account and capital account projections for next year produce an adjusted over-all deficit of about $3 billion, if we assume no abnormal outflows of nonbank private funds into foreign currencies or into Euro-dollars. This compares with a deficit of over $4 billion now expected for 1970. (Neither figure counts the receipt of SDR's allocated to us.) This year's official settlements deficit may surpass $8 billion. In the first 9 months of 1970 U.S. liabilities to foreign official reserve holders had already increased more than $5 billion. If liabilities to commercial banks abroad, including American bank branches, were to fall next year by $3 or $4 billion more--which is by no means out of the range of possibilities unless measures can be taken to prevent such large repayments--next year's official settlements deficit would be $6 or $7 billion. Part of that would surely have to be met with some use of gold, SDR's, and our reserve position in the IMF, to keep U.S. liabilities to foreign reserve holders from mounting excessively. Such a deficit, even though unlikely to be repeated in subsequent years, could create serious problems for the stability of the international monetary system.

Mr. Partee concluded the presentation with the following comments:

The outlook for the strength of economic recovery has deteriorated considerably over the past few months, in our view. In extending our forecasting horizon to include the latter half of next year, assuming the current posture of monetary policy, we find that real growth in output is not projected to return to the long-run norm of around 4 per cent at any time in 1971--apart from the post-auto strike surge in the first quarter. We still believe a recovery will occur next year, but it seems likely to be distinctly sluggish, given the monetary and fiscal policies assumed.

With real growth staying below a 4 per cent rate, employment gains would fall far short of the rise in the labor force, and the unemployment rate would rise above 6-1/2 per cent--the highest level since 1961.

Recently, as in the early years of the 1960's, increased attention has been given to the gap between actual and potential real GNP as a measure of the cost of unused resources. Our GNP projection for 1971--if realized--would imply a widening of the gap to about 7 per cent of GNP by the fourth quarter of next year--a dollar shortfall, in current prices, of some $80 billion.

There are problems with this measure, as with most summary measures of its kind. For example, the potential GNP as estimated by the Council of Economic Advisers is based on a 3.8 per cent unemployment rate. That may well be too low an unemployment target for sustainable economic growth without inflation, in which case the size of the gap is slightly overstated. Nevertheless, it seems fair to conclude that a huge amount of product would be lost next year if our projection is correct. Our earlier experience suggests, furthermore, that it would take some time to reduce such a large gap to tolerable proportions.

An extended period of slow economic growth usually takes a heavy toll in the industrialized sectors of the economy. If the recovery next year were fueled mainly by rising construction expenditures, as we project, total industrial production probably would not rise enough in 1971 to regain the midyear 1969 peak.

For durable goods manufacturers, the outlook would be especially weak. With output of business and defense equipment expected to fall further and, in the process, to moderate inventory investment in durable goods industries, production of durables at the end of 1971 is projected to fall short of last year's peak by about 8 per cent.

The threat posed by a prolonged period of weakness in industrial output is the possibility of precipitating a further deterioration of business and consumer attitudes. The recovery in production that will occur as auto production revives might then prove to be short-lived, and we could find ourselves in the midst of another downturn later on next year. The risks of error in the projection, therefore, seem to me mainly on the downside--given the assumed course of monetary and fiscal policy.

It may be, of course, that fiscal policy will prove to be considerably more expansive than we have assumed. We have not incorporated into the projections of Federal spending in fiscal 1972 the higher estimates mentioned in the financial press recently--because we have no present basis for doing so. But it does seem likely that some new programs will be pushed through; moreover, utilization of our projection would certainly increase the likelihood of deliberate actions to provide added fiscal thrust. But substantial additional fiscal stimulus might be difficult to propose and obtain, given the political problems associated with increasing an already deep deficit. My own inclination, in the absence of a new recessionary downturn, would be to depend principally on monetary ease as a means of reinvigorating the economy.

A policy mix featuring relatively more monetary ease would offer promise of reducing interest rates further. The 5 per cent monetary growth rate assumed in our projection would permit a decline in long-term interest rates--but to levels that are still extremely high for an economy in which investment incentives are lacking and real activity is showing little strength.

Persistence of inflationary expectations is one reason why interest rates may prove resistant to further declines. The greater source of the difficulty, however, arises from cost pressures that are likely to push up average prices at something like a 3 to 4 per cent rate next year. Because of this, the major part of the projected growth in money supply will be absorbed by increased transaction needs, even at an unchanged level of real demand, leaving relatively little excess to exert downward pressures on interest rates.

Viewed from the vantage point of the credit markets, the difficulty of getting interest rates to decline without greater monetary ease stems from continued heavy demands for borrowed funds. We are projecting Federal borrowing in calendar 1971 about $4 billion larger than in 1970, reflecting the increased budgetary deficit.

The total of private funds raised is also projected to increase next year--but to remain below the 1969 peak levels. Mortgage debt expansion should rise appreciably, and State and local governments will also be heavier borrowers. Furthermore, the projected gap between internally generated funds of businesses and their investment outlays--though diminishing--remains relatively large, so that business demands for external financing will still be substantial.

Some relief from tensions in capital markets is suggested, however, by the modest retrenchment projected for total offerings of corporate and municipal securities. The volume of municipal issues seems almost certain to rise next year, but we could have a more than offsetting decline in corporate issues if, as we expect, the banking system displays an increasing interest in term lending. Even so, the volume of corporate and municipal securities combined next year would be larger than in any year other than 1970.

In our projection last June, we gave the Committee quantitative estimates of the probable results of pursuing a course of monetary policy different from that underlying our formal GNP projection. Today, in view of the large and growing amount of slack we foresee for 1971, we have chosen an alternative policy course that deviates significantly from the present 5 per cent growth path desired by the Committee. Specifically, we have estimated the probable effects of money supply growth accelerating to an 8 per cent rate during the first half of 1971, then subsiding gradually to a 6 per cent growth rate in the final quarter of the year.

The impact of this more expansive course of monetary policy on GNP growth is, of course, a matter of substantial uncertainty. After reviewing what our econometric model has to say, and modifying its output by exercising our own judgments, we conclude that the course of GNP growth would be altered along these general lines. The first significant effects would begin to be felt during the second quarter, and by the latter half of next year we would expect quarterly increases in current dollar GNP to rise above $20 billion. In real terms, GNP growth would accelerate to about a 5 per cent annual rate in the last half of 1971. The effects of the additional stimulus to spending would be spread rather generally over a number of sectors, including residential construction, State and local government expenditures, consumption, and inventory investment, but we would not expect a material impact on business fixed capital outlays before early 1972.

A step-up in growth of real GNP to a 5 per cent rate would offer some promise of beginning to reduce the degree of resource slack before the end of 1971. According to our estimates, the unemployment rate consistent with the higher growth rate of real GNP would still be rising through the summer, though somewhat less than with 5 per cent monetary expansion. We believe that unemployment subsequently would turn down, however, ending the year a little over 6 per cent.

With substantial slack remaining in the economy, there would seem to be little risk of aggravating inflationary pressures significantly with the more expansive policy assumed. Our best guess is that the GNP deflator might be rising at about a 3.4 per cent rate at the end of next year, instead of the 3.2 per cent rate we estimated to be consistent with 5 per cent monetary expansion. In my judgment, this would be a price worth paying to halt the rise in the unemployment rate and to turn it down before next year is out.

There would be risks in moving immediately to lay the basis for an 8 per cent money supply growth rate. One concern is the possibility that fiscal policy might turn out to be more expansive than we have assumed, a prospect that we will be able to assess more fully early next year. Given the uncertainties of estimating the marginal effects of changes in policy, it perhaps would be prudent to move monetary policy more gradually while waiting for the evidence on budgetary intentions to come in.

Meanwhile, however, I would strongly recommend the first step toward a more expansive policy posture along the lines of alternative B of the draft directives[1/] as specified in the blue book.[2/] This alternative would involve an effort to restore the growth rate of money to 5 per cent in the fourth quarter, then moving on to a 7 per cent growth rate in the first quarter. With this alternative, the adjusted credit proxy would, we estimate, be rising at a little over a 10 per cent rate by the first quarter of next year.

The blue book has discussed extensively the difficulties of estimating money market conditions consistent with these target rates for the aggregates. I will simply state that the Manager would need to probe to successively lower Federal funds rate levels to find the present base for 5 per cent monetary expansion, and that a Federal funds rate declining considerably from current levels might well evolve in the

---

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

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

> process. (The $300 million in member bank borrowings we have assumed entirely reflects advances to a few banks under administrative discipline.)
>
> If the Committee should decide to remain with alternative A, it would be voting for an unchanged policy in the sense that the fourth- and first-quarter money growth rates would average out to 5 per cent. But we believe that a 4 per cent growth rate of the money supply in the fourth quarter would call for a little more easing in money market conditions from recent levels. The Federal funds rate might have to fall to the lower end of a 5 to 5-3/4 per cent range, with member bank borrowings staying close to the amount under administrative discipline. The easing in money market conditions contemplated should induce some further small decline in market rates, and hence would seem marginally consistent with continuation of the Committee's desire, as expressed in recent directives, to "promote some easing of conditions in credit markets."

Chairman Burns commented that the staff's presentation had been excellent. He then suggested that the Committee turn to a brief general discussion of the economic and financial situation and outlook.

Mr. Hickman said he had been in accord with the staff's assessment of the outlook in the June chart show but had some reservations about today's presentation. He thought there were several reasons for believing that the risks of error in the latest projections were mainly on the upside, rather than on the downside as Mr. Partee had suggested. First, while it was impossible to abstract statistically from the effects of the current auto strike since they ramified so widely, he suspected that the strike accounted for somewhat more of the recent weakness in industrial production than the staff had implied. Secondly, in his judgment the projections of Federal spending probably were too low. Also, the projections of Federal tax receipts might well turn out to be too high, although there were some offsetting factors in that area. On the one hand, support seemed to be growing for the restoration of the 7 per cent investment tax credit--a step which he thought had much to recommend it but which would, of course, reduce tax revenues. On the other hand, he thought the staff's projections of corporate profits--as well as the "actual" figures for recent periods--were too low; if so, the projected receipts from the corporate income tax would be understated.

Mr. Hickman added that the projections of unemployment could prove to be in error for much the same reasons as they had in the past. He also noted that the staff's recent projections of the GNP price deflator had consistently understated its rate of advance. Thus, while Mr. Partee had cited estimates indicating that the deflator would be rising at an annual rate of 3.4 per cent at the end of 1971 under the more stimulative policy alternative, the rate of increase might actually turn out to be about 4 per cent if the Committee adopted that alternative.

Mr. Mayo remarked that he also thought the projections of economic activity were a bit pessimistic. For one thing, business outlays on plant and equipment might well be a little higher than projected. For another, he would not be surprised if actual Federal outlays--as distinct from budgeted outlays--in fiscal 1972 exceeded the figure of $226 billion used in the projections. The expenditure figure proposed by the Administration next January might well be close to $226 billion--he had not discussed the matter with officials of the Budget Bureau--but he questioned the realism of formulating monetary policy on the assumption that Federal spending would in fact be held down to that level.

Nevertheless, Mr. Mayo continued, he concurred in Mr. Partee's conclusion that continuation of a 5 per cent target rate for money supply growth in 1971 would be inconsistent with the kind of economic recovery that might be considered to be a reasonable goal of policy. He recognized that such a conclusion raised a question about the balance of payments--a question to which he did not have the answer. At the same time, he thought the nation would be faced with a very serious problem if the economic conditions prevailing at the end of 1971 were similar to those portrayed in the staff's projection today.

Mr. Brimmer asked what the implications would be for the balance of payments if the more stimulative monetary policy recommended by Mr. Partee were pursued.

Mr. Hersey replied that the staff had not made specific estimates of the likely effects on the payments balance of that alternative for policy. With respect to the trade balance, more rapid expansion of the domestic economy would, of course, tend to increase the rate of growth of imports. But because imports were heavily influenced by other factors--including changes in world markets for materials, as the experience this year had demonstrated--any estimates of the impact of alternative policy courses would be highly uncertain. It was possible that the effect of the specific alternative course Mr. Partee had discussed would fall within the range of error of the projections given in the presentation. As to the capital account, one consequence of a more expansive monetary policy might be to encourage foreign buying of U. S. equities.

Mr. Solomon added that in the commercial banking area the major impact probably would be to increase the rate at which U.S. banks repaid Euro-dollar borrowings--a rate which was likely to be quite high even under a policy involving a 5 per cent target growth rate for money. Thus, one consequence of a more stimulative policy would be a more rapid buildup in the official settlements deficit--at least until Euro-dollar borrowings of U.S. banks reached minimum levels, whatever those might prove to be. The rate of bank credit expansion to foreigners might also increase somewhat in view of the amount of leeway existing under the voluntary foreign credit restraint program. As to other capital flows, he did not believe that direct investment outflows would be significantly affected since their volume was effectively limited by the OFDI program.

Mr. Partee noted that the staff's econometric model could shed some light on the question under discussion. In particular, it implied that the trade surplus in 1971 would be about $1 billion less under the more stimulative policy course than under the course involving a 5 per cent growth rate for money. The difference increased as the year progressed, reaching an annual rate of about $2 billion in the fourth quarter. On the other hand, as Mr. Hersey had suggested, U.S. equities should be more attractive to foreigners under the more expansive policy course, and rising foreign investment in stocks might offset all or a good part of the other effects tending to increase long-term capital outflows. In the short-run, however, the adverse effects of the more stimulative policy on Euro-dollar flows which Mr. Solomon had mentioned would undoubtedly be quantitatively more important.

Mr. Galusha said he would not attempt to debate the merits of the staff's numerical projections but would comment instead on the state of expectations. The business people he had talked with were very bearish about the outlook. For example, the head of a large national retailing concern was quite pessimistic about the coming Christmas season, and the head of a toy manufacturing company reported that retailers generally were holding down their orders. Computer manufacturers were unhappy about their prospects, since they were among the major victims of the general cost-cutting efforts by industry. Far from having run its course, such cost cutting appeared to be just getting under way.

Mr. Galusha remarked that it had taken a long time to cool off earlier inflationary attitudes, and now that expectations had become bearish it would not be easy to encourage more optimistic attitudes. In short, he agreed with the staff's judgment that the rate of growth in the monetary aggregates could be increased substantially without incurring costs--in the form of rekindled inflationary expectations--on a scale anywhere near that of the benefits that would follow in the form of increased employment.

With respect to Federal expenditures, Mr. Galusha was inclined to agree with Mr. Mayo that actual outlays in fiscal 1972 probably would exceed $226 billion. There were likely to be substantial pressures in Congress for higher expenditures and the Administration no doubt would have to make some concessions; but it would be desirable for the Federal Reserve to help the Administration resist such pressures. The possibility that fiscal policy might become unduly expansionary should not deter the Committee from stepping up the target growth rate of money at this time. The Committee was not formulating policy today for all of

1971, and it could back away from the more stimulative stance in coming months if fiscal developments made that appear desirable.

Mr. Hayes said he also thought the staff's presentation had been very good. His main reservation was similar to that expressed by Messrs. Hickman and Mayo--namely, that the margin for error seemed larger on the upside than on the downside. He was not an expert on the budget, but he had an uneasy feeling that there might be an undue amount of stimulus from fiscal policy over the next year or two. Economic visibility was particularly poor at present because of the pervasive impact of the auto strike, but it should improve considerably in coming months now that the strike apparently was ending. Accordingly, the Committee would be able to make a much better reading of the outlook for 1971 in a few months than it could at the moment.

Mr. Hayes concurred in the staff's view that an easier monetary policy would stimulate inventory building by business. His major concern, however, related to the outlook for prices, which seemed to him to be more gloomy than projected. He was dubious about the staff's judgment that following the more stimulative policy alternative would increase the rise in the deflator by only two-tenths of a percentage point in the fourth quarter of 1971. Unlike Mr. Galusha, he thought there was a good deal of inflationary tinder lying about waiting to be rekindled. In his judgment the progress to date in slowing price advances was more apparent than real. While recent productivity gains were welcome they seemed to be a short-run cyclical phenomenon reflecting special cost-cutting efforts, and they did not appear to be influencing pricing practices to any great extent.

Mr. Hayes then summarized certain additional remarks he had prepared, saying that he would submit their full text for inclusion in the record. The text of those remarks was as follows:

> It seems to me that the setting for policy decisions has not become any easier in the past month. On the one hand, I believe inflation remains our most serious and intractable problem--highlighted by the General Motors settlement which points to no diminution of upward wage pressures. On the other hand, the economy is behaving more sluggishly than many of us had expected, even after allowance for the effects of the General Motors strike. While unemployment for a fairly extended period in the 5 to 5-1/2 per cent range might be a reasonable price to pay for checking the inflationary spiral, I do find disturbing the prospect of further increases in unemployment for most of the year ahead. But I think that any attempt to force the economy back to full employment within a year and a half or so would be absolutely disastrous in view of the rates of real growth and of financial expansion such a policy would undoubtedly require.
>
> Balance of payments data continue to make very poor reading. In balance of payments terms, a stiff price is being paid for the easing of money market conditions in the United States. This should not pose difficult financing problems for the rest of this calendar year because of seasonal factors as well as the direction of money flows. Indeed, further repayments this year of Euro-dollar borrowings by American banks, within reasonable limits, might even be a welcome alternative to having the present huge overhang of Euro-dollar liabilities remain at such a high level as we enter a new and probably more difficult year. As

we look ahead international considerations underline the need for giving high priority to the inflation problem. Any signs of progressive easing in monetary policy would be reflected unfavorably in the sensitive exchange markets.

I am persuaded that the dilemma in which monetary and fiscal policy now find themselves points strongly to the need for further experimentation in the direction of some kind of incomes policy--possibly an effort to limit wage increases temporarily to amounts required to cover recent increases in the cost of living together with some token addition representing a part of national productivity gains.

Mr. Maisel said he would first like to congratulate the staff by pointing out that their projection for 1970 made a year ago was less than one-half billion dollars off the current estimate. There were, of course, offsetting errors in the projection but the general implications for desirable policy of the staff's work had been correct throughout the past year. Perhaps most important to note among offsetting errors was that the private economy had been less buoyant than projected. That showed up from the fact that the Government deficit was somewhat larger than assumed and that monetary policy was also probably somewhat easier than assumed. All of the monetary aggregates grew at a rate more than 50 per cent above that contained in the initial projection.

With respect to the coming year, it seemed clear to Mr. Maisel that the conditional projection presented today painted a basically unsatisfactory picture. It would leave the economy in the fourth quarter of 1971 with an unemployment rate of 6.7 per cent and a gap between actual and potential production of about

7 per cent, or over $75 billion at annual rates. That was a far larger gap than even the most pessimistic concern with price movements or balance of payments would suggest was logical. It would be a great misfortune for the economy if the staff projection turned out to be true. It was clearly the function of the Federal Reserve to use its available powers to try to make certain that demand increased at a much faster pace than shown in the projection.

Mr. Maisel said he would hold his specific suggestions for monetary policy until the go-around. At this point he would like to suggest that as a minimum the Committee should seek--without knowing whether or not it could achieve--a level of spending which would cut the projected shortfall in demand in half by the fourth quarter of next year, and would reduce the gap to no more than 1-1/2 to 2 per cent by the fourth quarter of 1972. In other words, the Committee's goal should be to have the shortfall of actual from potential output down below 4 per cent by the end of 1971 and much closer to 1-1/2 per cent by the end of 1972. Those results would be associated with unemployment rates slightly above 5 per cent at the end of 1971 and hopefully under 4-1/2 per cent by the end of 1972. That was a somewhat faster growth rate than the staff projected, but it was a goal worth striving for.

Mr. Maisel said he recognized, of course, that the Federal Reserve alone could not bring about the increased demand. It could, however, conduct monetary policy so that it made available the necessary funds at rates which would make the desired levels of spending possible. At the same time it should recognize that, given the degree of unused capacity which even those goals implied, what occurred in the price field would be independent of that action or other actions which the Federal Reserve could take. The System would still be following a path that would be completely anti-inflationary. Whether or not that deflationary pressure succeeded in slowing price rises would not depend on the System's action but would depend on the price policy actions of business, labor, and Government. For the Federal Reserve to assume that it had or should have powers in those fields as opposed to some influence over the level of demand would, he believed, be incorrect.

Similarly, Mr. Maisel believed it would be improper to assume that balance of payments considerations should be a constraint on those proposed goals. If the balance of payments remained unsatisfactory with demand still far below normal, that would appear to be an indication of basic structural problems in the balance of payments sphere. The Committee should be working to correct those structural imbalances rather than assuming a posture which traded off losses of income, output, and jobs in an attempt to offset basic structural defects in the balance of payments sphere.

Mr. Maisel said he agreed completely with Mr. Coombs that the Federal Reserve should not have a foreign monetary policy independent of other Government foreign policy. It should operate only on clear understandings of what objectives and tactics the Administration was trying to achieve and of what role they believed the Federal Reserve could play in its exchange operations to help achieve those foreign goals. He certainly did not feel that the Federal Reserve should adopt a less than optimum domestic goal without a clear understanding of Administration foreign policy goals. Before cutting back on domestic goals for balance of payments purposes, he would want to have a clear expression that such an attempt to lower demand would be in accordance with the Administration's views of proper national goals.

Mr. Coldwell said it seemed to him that the available data and interpretations thereof could be used to support either optimistic or pessimistic appraisals of the immediate outlook. He personally was inclined a little toward the pessimistic side. That was less because of general cyclical considerations than because of the pervasive effects of the curtailment of defense spending--which had been going on concurrently with the Committee's efforts to slow down the economy--and the pessimistic attitudes the defense cutbacks were creating among manufacturers.

If the staff's projection was correct, Mr. Coldwell continued, like Mr. Maisel he would be unwilling to accept the outcomes indicated for unemployment or for the shortfall of GNP below its potential as appropriate goals of policy. But he was not as pessimistic as the staff with regard to the over-all economic outlook, partly because he suspected that consumer spending would be stronger than the projections indicated. At the same time, he thought the downtrend over coming months in some industrial sectors might be greater than the staff expected.

Mr. Coldwell remarked that he would postpone his comments on current monetary policy until the go-around. He would note at this point, however, that he thought monetary policy would have to be supplemented by other measures in dealing with current stabilization problems.

Mr. Heflin observed that the General Motors strike apparently had tended to reduce aggregate demands for credit, with consequences for short-term interest rates and for the relationship between interest rate levels and movements in the monetary aggregates. He asked how the staff would assess the implications of the strike settlement for financial markets in coming weeks.

Mr. Partee commented that it was quite reasonable, in his judgment, to conclude that the strike had reduced over-all credit demands; with both new car sales and dealer stocks cut back by the strike, the financing needs of both consumers and dealers were lowered. It also seemed reasonable to assume that there would be a pickup in credit demands after the settlement--perhaps with a lag of three or four weeks until newly delivered GM cars would have to be paid for by the dealers. Mr. Partee noted that the plants probably would produce at capacity for a time even if sales were weak, in order to rebuild dealer stocks. While the auto strike had not been the only factor depressing credit demands recently--the weakness in business loans at banks had been quite widespread by industry--the resumption of production nevertheless should still have a significant impact on credit demands. The settlement of the auto strike also was expected to have important implications for the pattern of money supply growth.

Mr. Axilrod added that an analysis of financial developments around the periods of two earlier strikes in the auto industry--in the autumns of 1967 and 1964--tended to support Mr. Partee's observations about the probable effects of the strike on credit demands. During both of those earlier periods there had been a sharp slowing of expansion in business loans at banks while the strike was in process and a substantial increase in the growth rate after it was settled. Expansion of the money supply also slowed markedly during both of those earlier strikes, but the rate of increase did not pick up again in the immediately following months. In the current situation the staff expected the ending of the strike to stimulate business loan demand and possibly also growth in money--but not enough to produce a money growth rate of 5 per cent unless fairly easy money market conditions developed.

Mr. Daane said he shared the staff's assessment of the outlook for the very short-run. Specifically, he agreed with the general contours of the projection of a sluggish economy, in which there was no real bounce in either consumer or business spending. Nevertheless, and despite Mr. Maisel's reassurances regarding the accuracy of earlier staff projections, he (Mr. Daane) was skeptical about the precision of the relationships presented today between the money supply growth rate on the one hand and developments with respect to real GNP, unemployment, and prices on the other hand. Granted that the staff tempered the results produced by its econometric model with its best judgment--and that its judgment was very good--he felt that an analysis of the kind presented involved a risk of leading the Committee to an unduly narrow focus on the rate of growth of money *per se*.

Moreover, Mr. Daane continued, there was a question in his mind as to whether it would prove feasible to step up the rate of expansion of the monetary aggregates should the Committee decide such a course was desirable. There might be important technical problems in achieving a much higher growth rate for money in the present environment, in which loan demands had declined, bank liquidity had increased substantially, and short-term interest rates were down significantly from their peaks.

Mr. Daane added that he would also be disturbed about the possible implications for Euro-dollar flows of an effort to increase money growth. It was generally assumed that Euro-dollar repayments by U.S. banks would continue; his concern was that they might suddenly mushroom.

Mr. Gramley said he might comment briefly on the subject of the technical feasibility of achieving particular growth rates for money. The staff analysis suggested that a 5 per cent rate of growth in money would be associated with a rise in nominal GNP in 1971 of a little over 6 per cent--of which about two-thirds would represent price increases and one-third real growth. The analysis also suggested that under such circumstances short-term interest rates would be roughly stable. In fact, however, it might turn out that a 5 per cent growth rate for money was attainable only with declining interest rates. That would be the case if the economy proved to be weaker than projected, for then the transactions demand for money would fall short of that assumed. If, however, the projections were over-stating the strength of the economy, the urgency of maintaining--or increasing--the growth rate of money would seem to be that much greater.

In general, Mr. Gramley said, he thought it would prove to be technically feasible for the System to achieve any reasonable money growth rate--whether 5, 8, or 10 per cent--if it were willing to see interest rates decline far enough. It was possible, of course, that balance of payments considerations would lead the Committee to conclude that interest rate declines should be constrained; that subject was outside his field of competence.

Mr. Daane said he had raised the question of feasibility because of the current shortfall from the Committee's 5 per cent target for money growth and because of concern about the levels to which interest rates might have to decline to achieve a still higher growth rate. In the latter connection, he noted that the staff had indicated that the Federal funds rate might have to fall to 3-1/2 per cent under the more stimulative policy course. Such a funds rate would be exceedingly low in the current environment; and in fact a still lower rate might prove to be required. He asked whether the Manager had any comments.

Mr. Holmes replied that he could not be sure what Federal funds rate would be needed to achieve the indicated growth in the money supply. In his judgment that information could be developed only in the course of operations.

Chairman Burns remarked that Mr. Holmes had put his finger on the essence of the matter; it would be necessary to proceed on a step-by-step basis.

Mr. Francis commented that despite the excellent staff presentation he was not persuaded of the need for the added stimulus to the economy that would result from more rapid growth of money. Also, the terms of the General Motors strike settlement did not suggest that the expectations of either labor or management in this country were very bearish.

In spite of any difficulties of interpreting current data resulting from the automobile strike, Mr. Francis observed, he believed that steady progress toward reducing inflation was continuing to be made without severe losses in real product and employment. Data available just before the strike indicated that total spending was rising at a 4.5 per cent annual rate. That rate in the long run would be consistent with maximum potential real growth with little inflationary pressure. Because of the delayed effects of past excesses, however, prices had continued to rise markedly, and transitional cutbacks had occurred in production, employment, and profits.

Mr. Francis said that selecting a trade-off between the severity of the decline in production and the speed of eliminating inflation was a matter of judgment regarding the combination that would provide the most public good. Under the policy course the Committee had followed, progress had been made in slowing the rate of inflation. Unemployment so far had remained lower than during any other postwar effort to slow inflation. The economy had performed well in view of the restraint on total spending and the transition away from war production.

Mr. Morris said he would like to compliment the staff on having recognized so promptly the fact that emerging statistics were not compatible with its previous projections. He might note that Mr. Friedman, a consultant at the Boston Bank who had been working with the St. Louis Bank's model, had come up with results very close to those presented by the Board's staff today despite the fact that he had used a very different approach. Specifically, he had found that a 6-1/2 per cent annual rate of growth in the money stock would be required to achieve a 5 per cent growth rate in real GNP in the period from now until mid-1972, together with a reasonable degree of slowing in the price deflator over that period.

Mr. Morris added that he shared Mr. Daane's skepticism about any effort to establish precise relationships between growth rates in the money stock and in GNP. Nevertheless, he thought it was clear that the level of economic activity over the past six months had been well below the Committee's expectations. That was true even before the auto strike; August was an especially sluggish month. It should be noted that until the shortfalls of the past few weeks the money supply had been growing at a rate quite close to 5 per cent, suggesting that that rate was insufficient to produce the desired economic response. Also--and to his mind this was a key consideration--while the staff projections might be subject to large margins of error, it was highly unlikely that any reasonable policy course the Committee might set today would result in an over-heated economy in 1971; he agreed with Mr. Partee that the risks were all in the other direction. A more expansive monetary policy would probably aggravate the balance of payments problem, but it was necessary for the Committee to face up to the incompatibility between its domestic and international goals at present and to establish priorities. He would favor focusing on the needs of the domestic economy.

Mr. Swan said he shared the view of those who thought there were some real problems with the staff's projections. He personally had not detected any great change in the state of the economy over the past month or two. While visibility was admittedly poor, he thought there would be some pickup in activity now that the auto strike apparently had been settled. He was not aware of any widespread expectations of a significant recovery, but--abstracting from defense cutbacks--he did not think there was any great concern about continuing downward movements. Furthermore, in his judgment the kind of unemployment that resulted from defense cutbacks--which had been substantial in the Twelfth District--was not likely to be responsive to accelerated monetary expansion. All things considered, he believed the time had not yet come for an aggressive easing of monetary policy.

Mr. Mitchell commented that the members of the Committee could hardly help being disturbed by the staff's presentation, since none could contemplate an unemployment rate approaching 7 per cent with equanimity. Some members had suggested that the staff's analysis was wrong, but he had not heard any persuasive evidence in support of that view. While the uncertainties attaching to the projections might tempt members to hold to their individual predilections, he thought they should face up to the real possibility that unemployment was headed for levels they all would consider intolerable.

As to the money supply, Mr. Mitchell continued, there was quite a long way to go in returning to a 5 per cent growth rate, let alone attaining a higher rate; one had to crawl before he could run. The money supply was a poor guide to policy at the moment because of the biases in the numbers. But the other guides one might turn to--such as the bank credit proxy and long-term interest rates--also had been behaving in a highly unsatisfactory manner recently.

Mr. Mitchell added that he was surprised by Mr. Swan's comment to the effect that unemployment resulting from defense cutbacks was not likely to be responsive to a more expansive monetary policy. In his judgment Mr. Swan was underestimating the mobility of labor. People who had lost jobs in defense industries could shift to other industries, and the healthier the economy the better their chances of finding new jobs.

Mr. Swan agreed he had overstated the lack of response, but he thought that where such specialized resources were involved it would take a considerably longer time for a significant response to an easier monetary policy to develop.

Mr. Brimmer said he did not want to take exception to the staff's analysis; indeed, he thought the staff should be complimented. Nor would he debate the question of the probable direction of errors in their projections. Even if it were agreed that the major risk was that activity would be weaker than projected, he would suggest that it was up to the Committee to decide whether it was prepared to accept that kind of risk.

Mr. Brimmer remarked that he agreed with Mr. Morris regarding the need for priorities when there were conflicts among the goals of policy. However, he thought the Committee had already established certain priorities in the process of stressing over the past two years the need to moderate growth of production for the sake of containing inflation. What Mr. Morris was suggesting, then, was that the Committee should now reorder its priorities to increase the weight placed on holding down unemployment. In that connection, he would remind the members that the original objective with respect to inflation had not yet been accomplished. That was evidenced by the staff projection that the GNP deflator would still be rising at a rate of over 3 per cent in the fourth quarter of 1971. The question the Committee had to resolve was the extent to which it was willing to trade progress against inflation for progress on the unemployment front.

In a concluding comment Mr. Brimmer said he agreed that actual Federal expenditures in fiscal 1972 were likely to exceed $226 billion. If that were the case the economy would be subject to somewhat greater stimulus from fiscal policy, independently of any action the Committee might take.

Mr. Robertson observed that there seemed to be a good deal of pessimism around the table today. He would like to remind the Committee that, while the staff's projections of last year had turned out to be close to the mark, the projections made in 1968 had proved quite wrong. The Committee had overreacted in 1968 and he hoped it would not repeat that mistake now. He thought there was a good possibility that consumer spending over the rest of 1970 would be well above current expectations, and that in general the degree of pessimism now prevailing would be found to be unwarranted.

Mr. Hickman commented that while he too had been concerned about the recent shortfalls in the monetary aggregates, he thought they could be explained in part by the existence of a kind of liquidity trap, in which banks used deposit inflows to pay off Euro-dollar borrowings rather than to expand earning assets. He now expected a marked increase in loan demand at banks, at least temporarily. He also expected an increase in bank investments in municipals, an area they had been tending to avoid because of uncertainties about the tax status of such securities. In the Fourth District, at least, major banks recently had decided to participate more vigorously in the market for municipals.

Chairman Burns commented that he would expect changes in bank earning assets to depend primarily on the volume of reserves the System provided.

Mr. Hickman said his point was that better response by banks to the System's moderately expansive policy could now be expected if, as he thought, the banks' recent efforts to improve their liquidity positions had essentially been a short-run phenomenon. Indeed, the revision over the past week in the staff's projection of the annual rate of money growth in the fourth quarter--from about 2-1/2 to 3 per cent--might indicate that the shift he expected had already begun. If it continued, the final growth rate might not be very far from the targeted 5 per cent. A 4 per cent rate, which the staff apparently thought realistic, would be quite acceptable to him so long as the shortfall it would entail was made up in the first quarter of 1971.

Chairman Burns then called for the report of the Manager of the System Open Market Account on domestic open market operations since the preceding meeting. Written reports for the periods October 20 through November 11, 1970, and November 12 through 16, 1970, copies of which have been placed in the files of the Committee, had been distributed to the members before this meeting.

Mr. Holmes said that in view of the lateness of the hour he would summarize the statement he had prepared and submit the full text for inclusion in the record. He then summarized the following statement:

> Short-term interest rates again declined sharply over the period since the Committee last met, amid strong market expectations of cuts in the discount rate and in the prime rate. Behind these expectations were the sluggish performance of the economy, in part reflecting the GM strike; the high level of unemployment; the weakness of business loan demand; and a vigorous push by banks to expand investments in short- and intermediate-term securities. The actual cut of 1/4 percentage point in the discount rate last week came as something of a disappointment to some market participants, but there was only a momentary lull in the downward push of interest rates. Short-term interest rates have again moved substantially lower in the past few days, with average rates of 5.28 and 5.41 per cent established for three- and six-month bills in yesterday's regular Treasury bill auctions. These rates are 65 and 72 basis points, respectively, below those established in the auctions just preceding the last Committee meeting.

While long-term interest rates have been slow to respond to the easing of monetary policy this year, there has been growing evidence of some move recently. Rates on municipal issues--particularly in the 5- to 20-year maturity area--have come down mainly as a result of bank buying. And with the AT&T financing out of the way, long-term corporate bond yields have moved a touch lower. Despite a very heavy calendar this week there are some signs that the market finally can see some reduction in new financings in the coming months, and there are growing expectations of lower long-term yields ahead.

Most market participants seem to agree that the state of the economy has called for some easing of monetary and fiscal policy and for a relaxation of pressures on interest rates. Many market participants, however, remain skeptical about the success of official policies to contain inflation. There is still a lingering fear that the Federal Reserve, in an effort to get the economy vigorously moving upward again, may move so far towards monetary ease that it will undo whatever progress may have been made towards cooling off inflationary expectations. As far as fiscal policy is concerned, most market participants recognize that the slow rate of economic growth and the squeeze on profits will mean lower Government revenues. But there is considerable concern about the likely size of the over-all deficit and the potential expansion in the Government's claim on financial resources.

While credit market conditions have eased substantially over the past four weeks, the growth of money and bank credit appears to have been well below the rate of the first three quarters of the year and the Committee's targets. The blue book indicates that it may be well nigh impossible to get the money supply back to a 5 per cent growth rate in the fourth quarter--at least without driving the funds rate to a point so low that it would almost certainly convince the market that the Federal Reserve had given up all attempts to combat inflation. The blue book may indeed turn out to be right, and it has certainly performed a useful service in suggesting what interest rate tradeoffs various growth rate targets for money may entail. But we have often seen large revisions in the projections and indeed in what we thought were real numbers. We really don't know what the strike effects on the money supply were, nor what the post-strike effects may turn out to be. And we do not as yet have in hand the annual revisions in money supply data--which may affect seasonal patterns--that should become available shortly. Incidentally, I am not forecasting that we are likely to be revised back onto target, as happened in the third quarter. Indeed, it could well work out the other way. All I am suggesting is that there is even more than the usual uncertainty about the aggregate projections and their relation to money market conditions at this particular point in time.

Open market operations over the past four weeks shifted gears twice towards easier money market conditions in response to the apparent weakness in money supply and the credit proxy. Early in the period, when some modest shortfall from the Committee's targets seemed indicated, we aimed towards money market conditions in the lower end of the range specified in the October blue book. By November 5, however, it appeared that there had been very little growth in money and bank credit in October. Moreover, projections for the fourth quarter as a whole indicated that money supply would grow at only half the Committee's target rate, and that bank credit would also be very much below the targeted 9 per cent rate. With even keel conditions not a major constraint by that time, open market operations provided the reserves needed to ease money market conditions still further. Basically, we aimed at a Federal funds rate fluctuating around 5-3/4 per cent rather than the 6 per cent or slightly higher rate aimed at earlier. With short- and intermediate-term interest rates declining precipitously, we felt it unwise to give much more of a market signal than that.

Looking ahead to the remainder of the quarter, it is obvious that the Desk will need some careful guidance from the Committee on how far to push money market conditions if money and bank credit growth continue to fall short of whatever targets the Committee adopts today. The blue book suggests that the funds rate might have to fluctuate around 5 per cent to get a 4 per cent money supply growth rate over the current quarter. A move to a 5 per cent funds rate would, I believe, be interpreted by the market as a further significant easing of monetary policy, even if it were accompanied by a more moderate rate of growth in the money supply than we experienced in the first three quarters of the year. It would be accompanied by a further sharp--but perhaps not completely sustainable--decline in interest rates, and by strong expectations of another and perhaps larger cut in the discount rate. Moving the funds rate below 5 per cent in a short period of time would, I believe, tend to exacerbate fears that the System was moving too far and too fast. Of course, such fears might be lessened if the economy fails to rebound as expected from its strike-induced lull over the months immediately ahead.

There are two other matters that I would like to touch on briefly. First, as the Committee knows, the Treasury refunding--with a general assist from the easing of credit market conditions over the period--was an outstanding success. And the subsequent auction for cash of a $2 billion, 6-3/4 per cent, 18-month note certainly proved that the auction technique can save the Treasury money at a time when interest rates are tending lower. Further experimentation in different market climates and in longer maturities will be required, however, before we can say how useful the coupon auction will be as a regular debt management technique.

The second matter has to do with the lending of securities by the Federal Reserve System. As the Committee may remember, at the annual meeting in March this year the Committee reaffirmed and somewhat liberalized the authority to lend securities. At the same time, the staff undertook to report back to the Committee in about six months about the status of the program. Partly because of the pressure of other events--and partly because the lending program has worked so smoothly--we have neglected to do so, and I would like to repair that neglect at this time.

Basically, the lending of securities has continued at a steady pace since March. The failure problem still exists in the market, and System lending of securities continues to be helpful in avoiding a snowballing of the problem. The liberalization of terms authorized by the Committee in March does not seem to have resulted in any significant expansion of lending. On average, ten loans totaling $20 million were made each day during the eight months since March 1970, compared with eight loans totaling $18.5 million during the first four months of lending operations. The average daily balance outstanding was roughly $35 million in both periods. The largest amount outstanding was $140 million (on May 4, 1970) compared with $101 million in the earlier period. Last Friday we had nearly as large an amount on the books--$137 million--with 11 of the 20 dealers with whom we do business using the facility, including loans made by the Chicago Reserve Bank as well as the New York Bank.

> Although the Committee extended the maximum maturity of loans from three to five days in March, in most cases securities continued to be returned in one to three days. Penalty rates were charged in 26 cases where maturities had to be extended beyond the five-day limit, as the Committee authorized in March. Penalty rates were waived in a few cases because of unusual circumstances. The longest extension was five business days granted to a dealer who had some rather serious problems because of a fire in his new office building.
>
> All in all, I see no reason to believe that there has been any significant development since March that should change the Committee's decision to carry on with the program of lending securities.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period October 20 through November 16, 1970, were approved, ratified, and confirmed.

Chairman Burns then suggested that the Committee turn to a discussion of monetary policy. He noted that the staff had submitted three alternative drafts for the second paragraph of the directive, of which alternatives A and B corresponded to the two policy courses discussed in the blue book and the chart show. As he understood it, the objectives of alternative C were the same as those of A; alternative C differed from A in that it set forth those objectives with more specificity.

Chairman Burns said he might make a few introductory remarks before the go-around began. The Committee's problem in arriving at a policy decision at this meeting was unusually difficult because there were several closely related issues that had to be taken into account. The first concerned the shortfalls from target growth paths that had developed in the monetary aggregates. There had been virtually no growth in the money supply since August, and the expansion in bank credit had been well below expectations. Those shortfalls had been due in part to the auto strike, but he thought they also reflected an underlying weakness in the economy. In his judgment it was imperative that the Committee begin to take steps to offset the shortfalls from the targeted growth rate.

Secondly, the Chairman continued, the Committee had to give consideration to the limits it might want to set for the Manager's efforts in the period immediately ahead to promote greater growth in the aggregates, perhaps by indicating how far and how fast he should go in easing money market conditions. The shortfalls had been so large and so persistent that substantial easing might be required if the aggregates were to be put back on track. A third question was whether to instruct the Manager to expand moderately the size of his operations in Treasury coupon issues.[1/]

It should be recognized, the Chairman continued, that actions taken by the Committee today might bring about a need for

1/ On November 10, 1970, there were distributed two memoranda the staff had prepared in response to the Committee's request, entitled "Effects of System Buying of Treasury Coupon Issues on Longer-Term Interest Rates" and "Federal Reserve Open Market Operations in Federal Agency Issues." Copies of these memoranda have been placed in the Committee's files.

a further reduction in the discount rate in the near future, on the principle that the discount rate should be kept in close alignment with market rates. That being the case, he thought it highly desirable for the Reserve Bank Presidents to discuss the possibility of further discount rate changes with their boards of directors in the days and weeks ahead. In the same connection comments would be welcome during the go-around this morning regarding the desirability of making changes in the discount rate in terms of basis points rather than conventional fractions.

Finally, the Chairman said, while he believed that balance of payments considerations should not prevent the Committee from taking the policy actions it felt were required by the domestic economy, it should be recognized that such actions could well aggravate adverse capital movements, particularly repayments of Euro-dollar borrowings by U.S. banks. If those repayments threatened to exceed tolerable limits, the System--particularly the Board--should be prepared to consider measures, perhaps in the form of new regulations, to stem the outflow.

Chairman Burns then invited Mr. Hayes to begin the go-around. Mr. Hayes made the following statement:

> Our basic policy should remain one of encouraging moderate expansion of the money and bank credit aggregates. I am somewhat concerned over the shortfall in projected growth rates for the fourth quarter, but my concern is mitigated by recognition that the General Motors strike has undoubtedly been an important temporary factor reducing the demand for money and credit.

Something like a 4 per cent money supply growth rate for the quarter is perhaps the best we should expect or encourage.

It would seem appropriate for the Desk to maintain the somewhat easier money market conditions that have prevailed in the past week or two, with market interest rates roughly consistent with the new 5-3/4 per cent discount rate. I would hope that a funds rate fluctuating around 5-3/4 per cent, net borrowed reserves of about zero to $200 million, and a 3-month Treasury bill rate of 5-1/4 to 5-1/2 per cent would be consistent with a 4 per cent money supply growth for the quarter. If there turns out to be a continuing shortfall, however, the Desk should aim for easier money market conditions, but I would not like to see the funds rate move as low as 5 per cent over the next four weeks. To my mind it would be preferable if short-term rates were not to go so low as to encourage expectation of another discount rate cut in the near future. In view of our basic problems we should try to avoid any impression of rapid easing of monetary policy. We can well afford to go very cautiously until we can better appraise the economy's strength in the aftermath of the General Motors strike.

Purchase of coupon issues is a normal means of providing a part of the banks' year-end reserve needs, and under present conditions we might buy a few more than in most years while avoiding anything more than a cautious approach. I would not like to see us get into the morass of purchasing agency issues outright. As for Regulation Q, much as I would like to see the elimination of ceilings on all maturities of large CD's, I would regret such a step for the moment for fear that it would contribute to an impression of excessive cumulative easing. I would urge that new regulations with respect to Euro-dollars be avoided unless outward flows are so large as to threaten to pose a critical situation. With a discount rate cut only a week old, I would favor waiting a month or so before even considering a further reduction. And I would certainly hope that we would continue to move in fractions of not less than one-quarter.

As for the directive, I would be quite satisfied with alternative A. Although I agree that alternative C means the same thing, I would not like to see us

> start including specific numbers in the directive. They might better continue to be covered in comments of Committee members, reflected in the policy record.

Mr. Francis noted that since February the money stock had risen at about a 5 per cent annual rate, although the rise had not been steady. Money rose at a much faster rate for three months last spring, and at about a 2 per cent rate in the five months since May. To the extent that the restrained 2 per cent rate of growth was designed to offset the earlier faster rate, it might have been largely justified. But he feared that it had been caused in large part by the System's placing too much reliance on money market conditions in formulating and implementing policy. He believed money market conditions objectives had continued to play too great a role in the Committee's operations and that the Committee needed to correct that defect.

As far as the St. Louis Bank staff was able to measure or anticipate, Mr. Francis remarked, total spending had not been stimulated by the rapid spurt in money last spring nor depressed by the recent 2 per cent rate. However, if either of those rates were maintained a few months longer, experience indicated that spending would respond in an undesirable way.

In Mr. Francis' opinion, the problems encountered in recent months in attempting to achieve desired rates of money and bank credit expansion pointed up the desirability of revising the Committee's methods of achieving a money target. It was apparent that the present method of being guided by money market conditions in the very short run as a means of achieving desired rates of monetary expansion over longer periods worked badly. As noted in the blue book, the Committee had very little knowledge of the highly inexact relationships between measures of money market conditions and growth of monetary aggregates. He suggested that the staff be directed to study the relative usefulness of money market conditions as a means of guiding short-run open market operations in seeking desired growth in money and bank credit, compared with the more direct approach of focusing on aggregates which it could control with a high degree of certainty in the short run.

Mr. Francis continued to feel that a 5 per cent rate of growth of money from last February into 1971 would be most appropriate. His own staff's projections led him to believe that the Board staff's projections tended to overstate the rise in unemployment and the progress that would be achieved in fighting inflation if a 5 per cent growth rate was maintained. However, in view of the recent slow growth in money he considered it most important that the Committee exercise special care to revert to the 5 per cent trend. Adequate reserves for that purpose should be injected regardless of the effect on money market conditions. Money market conditions had misled the Committee in recent months, as they had time and again;

and he recommended that they be eliminated from the current directive. With that change, he thought alternative A would be generally satisfactory.

Mr. Francis said he was not at all persuaded of the necessity of the proposed program for purchasing coupon issues. On the subject of discount rates, he agreed with the Chairman that the directors of each Reserve Bank should continue to watch the situation closely and that the rate should be changed by small amounts to keep it in line with market rates. Finally, he thought the best long-term solution to the balance of payments problem would be a domestic stabilization policy that brought about a return to noninflationary economic growth.

Mr. Fossum said that under present circumstances alternative A of the draft directives seemed to be the most appropriate. As the blue book noted, to attain a growth rate in the money supply of 5 per cent in the final quarter of 1970 would require an extremely sharp reduction in short-term rates. Such a development, he believed, should be avoided if at all possible as being inconsistent with creating the impression that the System was following a moderately expansionary policy. The 4 per cent growth rate for the fourth quarter, with a somewhat higher rate in the first quarter of 1971, seemed more consistent with the policy the Committee had been following, and he would not be inclined to alter that policy at this time.

With the economic outlook as uncertain as it was at present, Mr. Fossum added, a shift to greater rates of expansion in the monetary aggregates did not seem appropriate to him.

Mr. Fossum noted that considerable study had been given at the Atlanta Bank to the question of whether it would be effective and desirable to operate in agency and coupon issues at this time. The conclusion had been that the case against undertaking such operations was the more persuasive. It was his hope that any activity in those areas would be no more than probing operations.

Turning to the discount rate, Mr. Fossum said he had been pleased that the recent cut had been interpreted in the money markets as a technical adjustment rather than as a signal that the System was moving to a more aggressive policy of ease. The latter would have been directly contrary to the wishes of his Bank's directors. They believed that in view of continued inflationary pressures a policy of greater ease than had been followed would not be appropriate. At the same time, the directors believed that postponement of action on the discount rate until money market rates had declined enough to justify a cut of one-half of one percentage point would have involved the danger of having the half-point cut interpreted as a major shift in policy.

Mr. Fossum observed that he would consider a further cut in the discount rate appropriate if money market rates should decline further in the weeks immediately ahead. However, he hoped the discount rate would follow rather than lead the decline. As to the possibility of denominating future changes in the discount rate in basis points, in the absence of some better reasons than those he now knew of, he would be inclined to avoid taking what might be a bewildering step. On the other hand, he would not object to making changes of one-eighth of a percentage point if that were considered desirable. That, it seemed to him, should provide sufficient ability to "fine tune" the rate.

Mr. Eastburn commented that, as the members knew, the Philadelphia Bank had been the last of the Reserve Banks to lower its discount rate to 5-3/4 per cent. The Philadelphia directors had delayed changing the rate as a means of demonstrating their great concern about the continuing problem of inflation. He personally shared that concern.

Mr. Eastburn said he was, of course, also greatly concerned about the levels of unemployment indicated in the staff projections; if those levels were realized the situation would be grave indeed. He suspected--although he could not document the view--that fiscal policy would be more expansionary than assumed in the staff's analysis. Also, he was skeptical about the prospects for an effective incomes policy.

On balance, Mr. Eastburn continued, he thought the Committee's objective at today's meeting should be to get back on the track of a 5 per cent growth rate for the money supply; as

Mr. Mitchell had remarked, one had to crawl before he could run. The Committee would be in a better position to decide on policy for the longer run at its next meeting, after there had been an opportunity to observe the pattern of developments following the end of the auto strike. Accordingly, he favored alternative A of the draft directives to alternative B. He also preferred A to C; although the former was the less specific, it had the advantage of employing essentially the same language as the directive issued at the previous meeting. Any necessary elaboration of the Committee's intent could be provided in the policy record.

Mr. Eastburn said he agreed that the discount rate should follow rather than lead market rates. He thought the discount rate should be used more sensitively in the future, with a number of small changes replacing a single large change as market rates moved down or up. If that course were followed, he would consider it vital to indicate to the market that the discount rate was being used in a manner different from the past. He had a strong preference for shifting to basis points in making discount rate changes because he thought such a step would provide the necessary signal. In his judgment the Philadelphia directors would have been more favorably disposed to a discount rate cut last week if the change contemplated had been in terms of basis points.

Mr. Eastburn added that the process employed in connection with the latest discount rate change had worked quite well; the reduction had been accomplished at all twelve Reserve Banks in the course of one week. It had been demonstrated that the only thing required for such expeditious action was a little special effort on the part of the Reserve Banks.

In concluding, Mr. Eastburn observed that he was somewhat sympathetic to exploratory operations in coupon issues, although he was not convinced that they would accomplish a great deal. He would not favor buying agency issues, because he believed that the objectives of such purchases could be better attained in some other way.

Mr. Hickman said he believed that target rates of growth of 5 and 9 per cent in the money supply and bank credit, respectively, were still appropriate, although the actual performance had been disappointing. Today he would favor the more modest of the staff's proposals, which included an average growth rate for the money supply of 5 per cent over the present quarter and the first quarter of 1971 and some further easing in money market conditions. As he had indicated earlier, he would expect some pickup in bank loan demand after the auto strike was settled and he believed that many banks were in the process of shifting to a more expansive investment posture. Thus, a sharp move now might cause the Committee to overshoot the mark later. If, however, banks failed to respond as he expected within the next four weeks, he would want to press harder for more vigorous credit expansion.

Accordingly, Mr. Hickman observed, he would favor alternative A for the directive. He preferred A to C because he thought the greater specificity of the latter would tend to restrict the Manager's operations unduly. He would oppose setting any lower limit for the Federal funds rate; both the funds rate and the bill rate should be permitted to fall to whatever levels were associated with the desired growth rates in the aggregates. However, he did not expect those interest rates to decline to exceedingly low levels.

Turning to the discount rate, Mr. Hickman said he would favor continuing to make changes in terms of fractions of at least one-quarter of a point. Changes as small as one-eighth of a point would not seem to be worth the trouble, and he thought market participants would have difficulty in understanding the reasoning behind a shift to basis points. The next regular meeting of the directors of the Cleveland Reserve Bank was scheduled for December 10, and he would expect to recommend another one-quarter point cut at that time if the bill rate remained around 5.30 per cent or had fallen to lower levels.

In connection with the proposal to purchase Treasury coupon issues, Mr. Hickman noted that the yield declines that had already occurred on such issues had opened up an unusually wide spread below yields on corporate bonds. Given that artificial market situation he thought the System should exercise a good deal of caution. However, he would not object to some probing action, particularly if rates began to rise again. He would not favor purchases of agency issues unless such purchases were considered necessary to carry out the intent of Congress. In the latter event he would confine operations to issues having maturities of one year and under, a maturity range in which operations would carry the fewest risks.

Mr. Sherrill expressed the view that the economy was weak and getting weaker. In conversations with people engaged in non-financial activities he found that attitudes were becoming increasingly pessimistic. If the staff's projections for 1971 were realized the nation would be paying a price, in terms of unemployment and underutilization of other resources, that was disproportionately high relative to the benefits that would be gained in the form of slower price advances. For the battle against inflation to take that form would, in his view, be unacceptable to the country.

In his judgment, Mr. Sherrill continued, it was fortunate that fiscal policy had not been any less stimulative than it had been. He believed that no combination of monetary and fiscal policies could cope with the existing problem of inflation without incurring very high costs. The solution to that problem had to be sought elsewhere--in the form of an effective incomes policy. He thought the Federal Reserve should do whatever it could to encourage the Administration to move in that direction.

As for current monetary policy, Mr. Sherrill said, growth in money at a rate of about 6 per cent would be appropriate in the existing economic environment. However, in light of the problems that had been encountered in trying to achieve a 5 per cent growth rate, it would appear that attainment of a 6 per cent rate would require an unduly large drop in interest rates; and that the growth rate associated with alternatives A and C was the maximum feasible at the present. The wording of C was attractive to him, but A also would be quite acceptable. In any case, he would favor permitting the Federal funds rate to decline to 5 per cent unless it appeared that the growth rate of money was exceeding 6 per cent--a development he did not consider likely. Hopefully, such a funds rate would be associated with a reasonable amount of expansion in bank credit.

Mr. Sherrill added that he would support the purchase of coupon issues as a means of encouraging declines in long-term interest rates. He also favored some limited experimental purchases of agency issues in view of the evident intent of Congress, although he was not hopeful that such purchases would prove useful.

Finally, he considered it likely that another cut in the discount rate would be appropriate within a few weeks.

Mr. Brimmer said that in his judgment alternative A was appropriate for the directive and alternative B was not. He thought the Manager should have some leeway in getting money supply growth back on the 5 per cent track, but he would not want him to press as hard as he probably would have to do to achieve a 5 per cent money growth rate in the fourth quarter taken by itself. In particular, it would be unwise to permit the Federal funds rate to go below 5 per cent, since it was desirable for the Federal Reserve to avoid the impression of stampeding toward ease. In that connection, he would second Mr. Robertson's warning about the risk of repeating the overreaction of 1968.

As to purchases of coupon issues, Mr. Brimmer hoped the Desk would use whatever opportunities were available to probe in that market, as it had at times in the past. He would favor giving some consideration to operations in agency issues as a longer-run matter, but not at present in view of the various other complications already affecting open market operations. Unlike some, he thought the System had a role to play in channeling funds in particular directions, but he was not convinced that the purchase of agency issues was the way to do it.

Mr. Maisel commented that, as he had said earlier, he believed the Committee's goal for 1971 should be to cut the gap between demand and potential output down from the level close to $80 billion projected by the staff under current monetary policy conditions to one only half as large. That would require growth in income a good deal more rapid than projected. If the relationship of the past four years between the growth in money and income continued to hold, it would require growth in M_1 at a rate of 8 per cent for at least two years. He agreed that no exact relationship of that sort could be expected to hold in the future, and he did not know whether or not money growth at an 8 per cent rate would turn out to be too high. If, however, an 8 per cent growth rate was considered as an upper constraint, any steps taken toward a more expansive monetary policy within that constraint would not be improper. It was possible to probe a great deal without worrying about overheating. The point to remember was that made by Mr. Gramley--that there was some relationship between demand for money resulting from output and how fast money grew. There was a self-correcting process in the relationship.

Since an 8 per cent growth path was high by historical standards, Mr. Maisel believed the System should use as many tools as possible to get the maximum amount of monetary impact with a somewhat lower rate of expansion in money. That meant getting as large a fall as possible in long-term interest rates with a given expansion of money.

With respect to the policy tools available, Mr. Maisel observed, in the first place he would support a more active discount rate policy. Given the fact that the three-month bill rate had fallen as sharply as it had, even with the minimal drop last week in the discount rate, he believed the System should be prepared to follow its previous statements and move the discount rate toward the market. At this time a rate somewhere between 5.40 and 5.50 per cent would appear to be logical.

Secondly, Mr. Maisel said, long-term rates probably had a greater impact on spending than short-term rates, particularly in the areas where spending was thought likely to increase--that is, the housing and State and local governments sectors--and in the plant and equipment sector, where hopefully the cutback would not be as large as was indicated. Accordingly, when furnishing reserves the System should furnish them in the longer end of the market. Such a procedure would simply follow the concept that if the demand for liquidity was great and borrowers were attempting to borrow long, the Federal Reserve should furnish its funds in the area of greatest demand.

With respect to the current directive, Mr. Maisel supported alternative B although he believed that the path of monetary expansion it projected was too low for the intermediate period. He did not feel it necessary to debate that point, however, since between now and the next meeting the problem would be to get back close to a logical path rather than to worry about what path the Committee should be on next year. While the greater exactness of alternative C might be useful, that alternative was not satisfactory because it called for too restrictive a monetary policy. However, he would be happy to add its final clause, relating to purchases of coupon issues, to alternative B. He would support moving the Federal funds rate to 5 per cent on the assumption that the expectational effects would be desirable.

Mr. Daane said he would comment in turn on each of the issues the Chairman had mentioned. As to the shortfalls in the aggregates, he still believed the Committee was guilty to some extent of "monetary aggregates myopia." He thought it would be helpful if there was less concentration on the aggregates--both internally and in public statements of System officials--and more attention paid to the other traditional indicators of monetary policy. In considering the latter one would note that there had been sharp declines recently in member bank borrowings, net borrowed reserves, and short-term interest rates. Long-term rates, however, had not declined as much as would have been desirable. He personally was less concerned about the weakness in the monetary aggregates than he was about the weakness in the economy. While he did not believe that monetary policy alone could deal with the problem, in view of the weakness in the economy he favored continuing the current process of easing within the context of alternative A.

Mr. Daane said he would favor placing limits on how far easing should go, particularly in view of the balance of payments constraint. He thought the Desk should resist declines below 5 per cent in the Federal funds rate. Although he would not want to include such an instruction in the directive itself, he thought its spirit should be reflected in the policy record for this meeting.

As to purchases of coupon issues, Mr. Daane said he would simply suggest that reserves be supplied by that means to the extent the Manager considered practicable, rather than naming any specific targets for such purchases. System operations in the long-term area would seem consistent with the Treasury's current attitude, as he understood it. Thus, the Treasury was considering raising needed funds by issuing a strip of bills because of its concern about the declines in domestic short-term interest rates relative to such rates abroad.

Mr. Daane observed that he would not want to see balance of payments considerations deter the Committee from taking needed policy actions. However, he was concerned about the possibility of large adverse capital flows, particularly since they could undermine efforts at international cooperation. Therefore, he would be sympathetic to special measures directed at limiting such outflows.

Finally, Mr. Daane said, while he would not prejudge any proposals for discount rate action, at the moment he thought another reduction in the very near future might be premature. In general, he hoped that the discount rate would be used not only to validate movements in short-term market rates but also to exert a pivotal influence on the structure of short-term rates.

Mr. Mitchell noted that of the members who had spoken thus far most favored the aggregate targets associated with alternatives A and C, and about half thought it would be desirable to set a 5 per cent floor under the Federal funds rate. For balance of payments reasons, he also favored trying to live with such a floor for the time being. It would be appropriate, he thought, to include a reference to the floor in the directive, in order to make clear to the public how seriously the Committee viewed the problem of adverse capital flows. Accordingly, he preferred alternative C for the directive.

Mr. Mitchell agreed with Mr. Maisel that the System should try to get as much mileage as possible from the various available tools. For that reason he favored an aggressive program of purchases of coupon issues. Although a number of studies had concluded that "operation twist" of the early 1960's had been failure, he was not convinced of that; and in any case he could see no harm in buying coupon issues aggressively. He also thought the System should begin buying agency issues of all maturities--not just short-term issues as suggested by Mr. Hickman. In his judgment the

Committee had temporized in connection with such operations for long enough.

As far as the discount rate was concerned, Mr. Mitchell added, he was attracted to the proposal to make changes in terms of basis points. Some of the attitudes regarding the discount rate that had been expressed this morning struck him as consistent with abandonment of the discount rate as a tool of policy. He would not want to see that happen. On the contrary, he thought the discount rate should be used actively to help bring about the kind of money market conditions that appeared desirable.

Mr. Heflin said he saw no reason for the Committee to change its targets for the aggregates at this time. He agreed with the view that judgments about the relationships between money market conditions and growth rates in the aggregates were so uncertain as to make it necessary to probe toward the appropriate market conditions. He would prefer to keep the Federal funds rate in the upper part of the specified 5 to 5-3/4 per cent range, permitting it to decline only if necessary for the sake of the aggregates. He had no objection to occasional purchases of coupon issues. However, he saw no need for referring in the directive to such purchases, or to a specific Federal funds rate. Either alternative C with deletion of those references or alternative A would be acceptable to him.

On the question of the discount rate, Mr. Heflin said he would have no objection to a further change soon so long as it was following rather than leading the market. But he would like to remind the Board that the Reserve Bank directors were becoming increasingly frustrated with the mechanism used for making changes in the rate. They felt that for the most part they were simply rubber-stamping changes that had already been decided upon elsewhere in the System. He hoped the directors could be kept in the ball game; at the moment they felt left out.

Chairman Burns said he thought that problem would be ameliorated if the directors were actively to debate the subject of the discount rate at every meeting. It was partly for that reason that he had been suggesting that the Reserve Bank Presidents keep the matter under continual review in meetings with their boards.

Mr. Heflin agreed that the course the Chairman had suggested would reduce the problem, although it probably would not eliminate it. He added that some educational effort might be desirable in conjunction with the new philosophy of smaller and more frequent changes in the rate. He would urge that the whole matter be given high priority at the approaching Conference of Chairmen.

Mr. Clay noted that there had been considerable concern recently over the performance of the national economy and the growth in the monetary aggregates. As to the latter, he was not persuaded that the shortfalls would prove as large as some around the table seemed to think, but it was clear that the Committee's goal had not been achieved. The General Motors strike had been an important factor in the economic situation, although it was not the whole story. It was impossible to know just what the future shape of events would be, even when allowance was made for a reversal of the impact from the motor strike.

However, Mr. Clay said, he thought it was necessary to place in perspective not only the months ahead but also the basic underlying situation of the price inflationary splurge that had led to the present difficult situation, and to ask whether the basic problem would not be aggravated by markedly stimulating monetary expansion at this stage. One factor that had to be recognized was the prospective volume of Government spending. Another factor was the strongly entrenched wage-cost push. The latter had been developing over a period of years, and had become an extremely serious matter. While it was not within the jurisdiction of the Federal Reserve, the country had to meet that problem and solve it, or else there was not much hope for developing orderly economic processes with relatively full employment of resources and reasonable stability of prices. That was not an advocacy of a harness of wage and price controls. Rather, it was a recognition of the necessity of some basic changes in the institutional arrangements whereby wage rates and prices in major industries were determined. That would in no way reduce the importance of appropriate monetary and fiscal policies, but it would enable them to be formulated effectively.

In view of the current economic situation and the accompanying shortfall in the growth of the monetary aggregates, Mr. Clay thought that some modification of policy as suggested in draft policy alternative A might be in order. However, any effort to regain lost ground in the rate of monetary expansion, so as to reach previously stated goals in credit and money for the current quarter, would involve unwarranted risks on the inflationary side. Neither did it appear to be in order to make a firm commitment at this time concerning the first quarter of 1971. The better course was to undertake slightly more monetary expansion than was being attained and observe developments on both the economic and financial fronts as they unfolded, including the after-effects of the motor strike settlement. Then the next step could be determined. The approach underlying draft policy directive B, on the other hand, would run the extremely high risk of inducing another round of intensified price inflationary developments and extremely tight and distorted credit markets. Alternative A also would be preferable to alternative C.

Mr. Clay recalled that when "operation twist" had been under consideration he had taken a strongly favorable position. Now, however, he would not consider an expanded program of System operations in coupon issues to be a desirable step. There were real questions as to whether such a program would be successful and whether it might not have greater negative than positive results if conducted on an aggressive scale. And, considering that it was the yields on non-Government issues that were the objective of the proposal, it probably would require an aggressive and continuing approach to have a significant impact on those yields. The demand for funds in those sectors of the market was tremendously strong. Indeed, over a period of weeks and months, the program might prove to be a destabilizing factor in the credit markets. Moreover, it probably would raise serious questions as to the Federal Reserve's basic views on the long-run stabilization of the economy.

With respect to expanded operations in agency issues, Mr. Clay continued, the question remained essentially the same as earlier. The matter was not one of principle as such, but rather one of what was feasible and practical. The fragmentation of the market and the related excessive impact on those issues of System purchases remained the key problem. Presumably the pressures on the Committee from some sources to undertake an active role in that area were strong. In terms of the problems involved in such a program and the impact on those securities, however, it still appeared to be an inappropriate undertaking.

Mr. Clay hoped that the discount rate would be kept at meaningful levels in the future through both increases and decreases as conditions required. That approach should result in more frequent changes than had been true at times in the past. It was possible that another discount rate change would be needed in the near future, but the necessity for such action was not apparent at the present time. The logical course seemed to be that of watching developments closely and determining the discount rate as such evidence became available.

Mr. Clay concluded with the comment that making future discount rate changes in terms of basis points rather than the conventional fractions appeared questionable. The main argument against that procedure was that it would be less readily understood; it would be confusing to the public and to a large proportion of small and moderate-size banks.

Mr. Mayo said he agreed basically with the staff's conclusion that some further easing of monetary policy would be appropriate at this time, despite the skepticism he had expressed earlier about the level of Federal spending assumed in the projections. He had some difficulty with the clause of alternative B that called for somewhat greater growth in money "than sought earlier," since his concern was not with what had been sought but rather with what had been achieved. However, he thought alternative B still was a better directive than A because it would give the Manager sufficient flexibility to accommodate a 5 per cent growth rate for money in the fourth quarter in the event that it proved possible to attain that rate after all. He saw no need today to specify a target for money growth beyond the fourth quarter; that action would best be reserved until the December meeting, when more information would be available on prospects for the first quarter. He would have no inhibitions about permitting the Federal funds rate to drop below 5 per cent. If, for example, it proved necessary to lower the funds rate to 4-1/2 per cent in order to achieve the desired monetary growth, he thought no damage would be done to the Committee's over-all objectives.

Mr. Mayo observed that he was opposed to operations in agency issues. Because of the nature of the market, System purchases would inevitably favor some sectors of the economy--such as agriculture or housing--over others, and that could raise serious problems. Even more so than with Treasury coupon issues, there would be a tendency to make the program a one-way street--buying but never selling. However, he would favor modest purchases of coupon issues, with the precise pattern and dimensions of the operation left to the judgment of the Manager. Such purchases might have a useful psychological effect on the market, and help the Federal Reserve achieve its over-all monetary objectives with less danger to the balance of payments.

Mr. Mayo said he would favor "watchful waiting" with respect to the discount rate. He would have no inhibitions about recommending another quarter-point cut to his directors as early as the next board meeting if the declines in market rates of the past day or so proved lasting. He was not in favor of beginning to denominate discount rate changes in basis points at the present time. He thought such a step would be premature in light of the discount rate study that the Conference of Presidents presently had under way.

Mr. Mayo added that he would suggest a change in the last sentence of the first paragraph of the draft directive, which described the broad objectives of Committee policy. The draft retained the language of other recent directives indicating, in part, that the Committee sought to foster "orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth...." Like other members of the Committee he remained deeply concerned about the problem of inflation, but he thought the Committee's first order of business now was that of encouraging the resumption of sustainable growth. Accordingly, he would propose a revision of the statement to list that objective before that of reducing the rate of inflation.

Mr. Daane remarked that while he had some sympathy with Mr. Mayo's view, he was concerned that when the directive was published such a revision might be misinterpreted as indicating that the Committee had abandoned the fight against inflation.

Chairman Burns called for a show of hands on Mr. Mayo's proposal, and noted that the proposal did not appear to have the support of a majority of the members.

Mr. Galusha said he agreed with Mr. Sherrill's comments on the directive, and like the latter he favored alternative C.

However, he would prefer to observe unfolding developments before deciding on a first-quarter target growth rate for money, rather than agreeing now to adopt the 6 per cent target suggested in the blue book. Also, he thought that considerable importance would attach to the state of money market conditions in coming weeks. He would encourage the Manager to keep testing, insofar as practicable, to determine the conditions that were likely to prove consistent with attainment of the desired growth rates for the aggregates in the fourth quarter.

As to the discount rate, Mr. Galusha thought that a further change would become appropriate soon if other System actions produced the results intended. Whether such changes were denominated in basis points or fractions was not important to him. He suggested, however, that if neutralization of some of the announcement effects of discount rate changes was desired, consideration should be given to adopting the proposal for redesign of the discount mechanism that had been outstanding for over two years. The present struck him as a particularly appropriate time for that action.

Mr. Hayes noted that certain features of that proposal were now under active study by the Conference of Presidents.

Mr. Swan said he favored alternative A of the draft directives, but without any commitment to a specific target rate for money growth in the first quarter; as others had suggested, a decision on that score would best be postponed until the December meeting. As to money market conditions, he did not believe--given the recent behavior of the aggregates--that System operations to reduce the Federal funds rate to 5 per cent would be considered by the market as "pushing the panic button." Also, he felt that some operations in coupon issues were not likely to be harmful. However, he preferred not to refer specifically in the directive itself to either the funds rate or coupon operations. Also with regard to the directive, he thought the two sentences in the draft of the first paragraph relating to wages, unit labor costs, and prices were awkwardly phrased and potentially misleading.

After discussion it was agreed that the sentences in question should be revised to read: "Wage rates generally are continuing to rise at a rapid pace, but gains in productivity appear to be slowing the increase in unit labor costs. Recent movements in major price measures have been erratic, but the general pace of advance in these measures has tended to slow."

Mr. Swan then observed that in his judgment some members of the Committee were over-estimating the difficulties that would be involved in modest purchases of agency issues. He agreed, however, that the present was not a good time to launch a new operation of that type. As to the discount rate, he thought the System should continue the policy of keeping it more closely aligned with market rates--a policy that would, of course, require more frequent changes than in the past. It was desirable, however, to avoid overly frequent changes; it should be determined that a particular movement in market rates was lasting rather than transitory before the discount rate was adjusted to conform with it. Also, it should be agreed that in principle the objective of keeping the discount rate in line with the market might require a change in either direction at any given time. He preferred using basis points for denominating changes; he doubted that any initial confusion caused by a shift to that procedure would last very long. However, he favored postponing the innovation until the results of the study presently under way became available.

Mr. Coldwell expressed the view that monetary policy was contributing to the solution of the problems currently existing in the economy. While it could not do the job alone, it could provide some of the elements necessary to an appropriate environment. Contrary to some, he thought it was the behavior of the monetary aggregates rather than that of money market conditions that at times had led the Committee astray; the instability in the projections of those aggregates had been a serious problem in the last few months.

As to policy, Mr. Coldwell said he would prefer a cautious probing toward a little more ease. He would not want to overreact to current economic conditions, nor would he attempt to recapture past losses in the monetary aggregates. Like some others, he was skeptical about the reliability of any precise forecasts of economic activity, unemployment, and so forth on the basis of assumed relationships with the growth rate in the money supply. On other grounds, however, he did share some of the staff's pessimism about the economic outlook. Given the current environment, he would recommend seeking free or net borrowed reserves in a range of $100 million on either side of zero and both a bill rate and a Federal funds rate in the range of 5-1/4 to 5-1/2 per cent. He would favor having the Desk limit any decline in the funds rate to a level a little above 5 per cent. For the directive he preferred a version somewhere between alternatives A and B. He did not want to use language as specific as that of alternative C.

Mr. Coldwell said he would support purchases of coupon issues within the traditional framework of the Manager's authority. He would not want to move aggressively in that area because of the risk of suggesting that the System was pegging the market. He opposed operations in agency issues on both philosophical and practical grounds.

As to the balance of payments, Mr. Coldwell thought the fundamental problem was a matter that fell outside the System's sphere of responsibility. While it was necessary for the Federal Reserve to give attention to international rate relationships, he thought that the present System policy decisions should be based mainly on the needs of the domestic economy.

Mr. Coldwell said he might support a further change in the discount rate soon, but would prefer to wait to see how market rates moved in the next few weeks. He noted that the regular meetings of the Dallas board of directors were held at monthly intervals, and that it would be about three weeks before the directors would be able to discuss the matter unless a special meeting was called. He believed that some modifications in the arrangements for changing the discount rate probably would be needed if those changes were to become more frequent. He was opposed to the use of basis points for the discount rate because he thought it would lead to some confusion.

Mr. Morris said he favored alternative B for the directive because he believed a considerable amount of evidence had now been accumulated to support the view that the current stance of policy was not sufficiently expansionary. Although the money supply had grown at an annual rate of about 5 per cent through the third quarter, data for late August and September--before the auto strike could have had any significant effect--indicated that economic activity was falling short of expected levels. That to him constituted a _prima facie_ case for a more vigorous expansionary policy, at least for a short period. It seemed clear that aggressive action to reduce short-term interest rates was needed to achieve the desired flows of funds into mortgages and State and local government securities. If alternative B were adopted, which he realized was unlikely, the Manager should be instructed to implement the change in an orderly fashion, reducing money market rates gradually and steadily so as not to give the impression that monetary policy was out of control.

Mr. Morris thought the Manager should have general authority to operate in coupon issues on a modest scale when such transactions appeared desirable to help meet the Committee's objectives. He would, however, oppose the kind of massive operation described in the staff's memorandum. For one thing, he believed that such an operation would not achieve its objectives; while it would depress rates on long-term Treasury securities, it would not have much impact on the long-term rates that were of greatest significance at the moment--those on mortgages and State and local government issues. Beyond that, it would involve the cost of creating within the Committee what in another connection had been called the "illusion of adequacy"--the illusion that something was being accomplished when it was not.

Chairman Burns asked whether Mr. Morris would still have misgivings if the operation were to be undertaken as an experiment, without any illusions.

Mr. Morris said he would. He observed that such an experiment had, in a sense, already been performed with negative results, when "operation twist" was undertaken in the early 1960's. One deficiency of the staff memorandum was that it contained no analysis of that earlier operation. For the Committee to embark on the proposed program now would suggest that it thought it could reconcile its domestic and international objectives by tilting the yield curve. In his view that would be a delusion; he was convinced that there was no substitute for a marked reduction in short-term rates if domestic objectives were to be achieved.

As for agency issues, Mr. Morris said he understood that it was still the Manager's position that the market did not have sufficient depth for effective Federal Reserve operations. Unless the Manager had changed that view he would not support purchases of agencies.

Turning to the discount rate, Mr. Morris said he favored using reductions in that rate to validate the successively lower levels of short-term market rates which he thought should be sought through open market operations. In his view it was unfortunate that the recent rate cut had been to 5-3/4 rather than to 5-1/2 per cent; the market's unenthusiastic reaction to the cut suggested that it had not been large enough. He had no objections to making changes in basis points, but saw no real need for doing so.

Mr. Robertson said he would summarize the statements he had prepared on monetary policy and on operations in agency and coupon issues, and would submit the full statements for inclusion in the record. He then summarized the following statement on the economy and monetary policy:

> The current economic picture presents a mixture of strengths and weaknesses which is difficult to evaluate. The dampening effects of the auto strike are evident, and some other factors also appear weak. But at the same time prices are continuing to rise rapidly and wage pressures, apparently including those that will come from the settlement of the strike, remain intense. One of the key areas of uncertainty at present seems to be that of consumer spending. I think the coming period of Christmas sales may serve as a useful testing ground for that sector and give us a clearer picture of its underlying condition.
>
> Under these circumstances, I think the appropriate policy for this Committee is one which would, over the course of the next few months, carry us toward a 5 per cent growth path for the money supply. I would not favor unusual efforts to achieve this growth rate for the fourth quarter, since this would seem to require more whip-sawing of money market conditions in the remaining weeks of this year than I think worthwhile. But our professed target for money supply growth has been 5 per cent for some time; and I think we must make a determined move to achieve that path gradually over the fourth and first quarters, while paying attention to money market conditions only to the extent necessary to insure that they are making a constructive contribution to the achievement of the kind of monetary growth and broad credit conditions that we seek.
>
> I would not, at this stage, favor a 6 or 7 per cent target, since the additional easing associated with such a policy would serve to encourage demands for higher and higher wages.
>
> Connected with my monetary policy views this morning is a fervent hope that the Administration will at long last take steps to convince labor and management that they too have a public duty to cooperate in battling inflation by holding down wage and price increases.

In terms of instructions to the Manager, I am in favor of alternative A of the draft directives as submitted by the staff, but as interpreted in the light of these comments.

Mr. Robertson then summarized the following statement on operations in agency and U.S. Government coupon issues:

This Committee has debated the pros and cons of these questions time after time over the past two decades. Our actual operating experience over that interval, I would say, has--or at least should have--tempered the extremes on both sides of the issue. At this stage, I think the biggest risks associated with a moderate-sized Desk operation in these securities boil down to the risks of too-great expectations. In that phrase, I mean to include false hopes on our part as to how much we can really move interest rates permanently by such operations; misinterpretations by market participants as to how strongly we will strive for particular interest rate levels; and delusions on the part of hard-pressed Federal agencies as to how much help we will give them in their market financings. If--and this is a very big "if"--all parties concerned are conditioned from the very outset to have only humble aspirations for these operations, then I believe we could undertake them with no great harm, even though with very little benefit.

Our open market purchases and sales should be carried on in the area of the market where we can operate with the least effect on market prices. The bill area is usually best for that purpose. But when we need to supply reserves, when bills are in short supply, and when some coupon issues are amply available, I think it is not unreasonable to do some part of our buying in those issues. This is simply a case of adjusting our demand to relative market supplies--i.e., to the area of the market where there is an overhang and where we can operate with the least interference with market forces.

It may be that such an operation in some circumstances would tend to move longer-term rates a bit lower relative to short-term rates for a time, and that might be well and good in the light of our credit policy objectives of the moment. But I think the surest way to prejudice such an operation is to count

> on its having a big or lasting interest rate impact. If we are to launch a program of buying coupon issues, we should treat the probable rate effect as a desirable, but not-to-be-counted on, by-product of a pragmatic reserve-supplying operation--not an end in itself.
>
> If we are to operate in coupon issues, we should begin making small-size outright System purchases and sales of the most marketable Federal agency issues. If we are to give even minimal obedience to the intent of Congress in granting us such authority, we should begin to experiment in agencies so that we can speak from experience and not simply from hypothesis in this field.

Chairman Burns said he would undertake to summarize the discussion in order to ensure that the thinking of the Committee on the several issues considered was conveyed adequately to the Desk. First, it was generally recognized that there had been a significant shortfall in the aggregates relative to their target paths, and that a correction was necessary. Secondly, it was generally recognized that in order to promote more rapid growth in the aggregates some easing of money market conditions was unavoidable and should be undertaken. Next, in the view of a majority of members--although not all--operations in coupon issues on a moderate scale would do some good or at least no harm.

With respect to the discount rate, the Chairman noted that the directors of one Reserve Bank had already voted to reduce the rate to 5-1/2 per cent, so that the Board of Governors would be debating the issue in the near future. That fact emphasized the importance of active discussions by the boards of directors of all Reserve Banks.

It appeared, Chairman Burns continued, that the Committee members recognized the risk on the international side of moving to lower interest rates, but most thought it was necessary to take that risk. The situation perhaps had not yet reached a stage at which strict regulatory measures by the Board of Governors were necessary, but the Board would remain alert to the possible need.

Turning to the directive, the Chairman noted that most members seemed to be inclined toward alternative A and he suggested that the Committee vote on that alternative. He assumed it was understood that the meaning of A was spelled out in more explicit terms in alternative C.

Chairman Burns then asked whether there were any objections to his summary of the discussion.

Mr. Robertson said that while he favored alternative A, he would not want it interpreted as equivalent to alternative C. In particular, he objected to the language of C which read "...permitting the Federal funds rate to decline to around the 5 per cent level if necessary...." because it implied that the Committee was setting a 5 per cent floor for the Federal funds rate. He did not favor such a floor.

Messrs. Hickman and Francis concurred in Mr. Robertson's comment.

Mr. Mitchell said he questioned whether it would be appropriate at this juncture for the Committee to place on the Manager the responsibility for deciding whether or not the funds rate should be permitted to fall below 5 per cent.

Mr. Hayes observed that he had no objections to the Chairman's summary, but nevertheless hoped that the funds rate would not fall as low as 5 per cent.

Mr. Daane remarked that like Mr. Robertson he would not want A to be interpreted as equivalent to C, but for different reasons. He was skeptical about the language of C which called for "...making up in coming months the short-fall from the desired monetary growth path that has developed recently...." While he hoped the performance of the aggregates would be improved in coming months, he would not want to issue that kind of instruction to the Manager at this time.

Mr. Brimmer said he would prefer to have alternative A interpreted on its own terms. He noted that its language differed substantially from that of C.

Mr. Partee observed that the staff had formulated alternative C so as to be consistent with the general specifications for the aggregates and money and credit market conditions associated with alternative A in the blue book. The intent had been to suggest possible language if the Committee desired to set forth its instructions with more explicitness than in alternative A.

Mr. Robertson commented that whatever the intent underlying C he would not favor interpreting A as establishing any particular floor for the Federal funds rate.

Chairman Burns remarked that the language of C served the additional purpose of making it clear that the Committee would consider a reduction in the funds rate to 5 per cent to be appropriate if necessary to achieve the goals for the aggregates. In the absence of such an interpretation the Manager might feel obliged to keep the funds rate at or above some higher level such as 5-1/2 per cent.

Mr. Hayes expressed the view that the specifications given for A in the blue book, taken together with today's discussion, provided the Manager with adequate guidelines regarding the Committee's intent.

Mr. Mitchell disagreed, noting that there appeared to be a substantial body of sentiment on both sides of the question of a floor for the funds rate.

Chairman Burns then asked the members to indicate whether they would favor having the Desk reduce the Federal funds rate to 5 per cent--but not lower--if that was found necessary to attain the Committee's goals with respect to the aggregates. Seven members (Messrs. Burns, Hayes, Brimmer, Daane, Heflin, Mitchell, and Sherrill) indicated that they would favor such a course. Five members (Messrs. Francis, Hickman, Maisel, Robertson, and Swan) indicated that they would favor having the Desk reduce the funds rate below 5 per cent if necessary to attain the goals for the aggregates.

Chairman Burns then suggested that the Committee vote on alternative A with the thought that the members' views on the issue would be quickly ascertained in the event the funds rate reached a level around 5 per cent and it appeared that the response of the aggregates was inadequate relative to the targets.

There was general agreement with the Chairman's suggestion.

Mr. Maisel indicated that he would dissent from the directive. He summarized his reasons, noting that he would submit a fuller statement for inclusion in the record.

With Mr. Maisel dissenting, the Federal Reserve Bank of New York was authorized and directed, until otherwise directed by the Committee, to execute transactions in the System Account in accordance with the following current economic policy directive:

The information reviewed at this meeting suggests that real output of goods and services is changing little in the current quarter and that unemployment has increased. Part but not all of the weakness in overall activity is attributable to the strike in the automobile industry which apparently is now coming to an end. Wage rates generally are continuing to rise at a rapid pace, but gains in productivity appear to be slowing the increase in unit labor costs. Recent movements in major price measures have been erratic but the general pace of advance in these measures has tended to slow. Most interest rates declined considerably in the past few weeks, and Federal Reserve discount rates were reduced by one-quarter of a percentage point in the week of November 9. Demands for funds in capital markets have continued heavy, but business loan demands at banks have weakened. The money supply changed little on average in October for the second consecutive month; bank credit also was about unchanged, following a slowing of growth in September. The balance of payments deficit on the liquidity basis was at a lower rate in the third quarter and in October than the very high second-quarter rate, but the deficit on the official settlements basis remained high as banks repaid Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead, with allowance for temporary shifts in money and credit demands related to the auto strike. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Mr. Maisel's statement read as follows:

I have dissented from this action because I believe that the objectives for prospective growth in money and credit which the directive attempts to achieve are unsatisfactory. In my view, the information developed at this and prior meetings on the state of the economy and its prospects should have led the Federal Open Market Committee to reconsider and change the policies it had previously adopted. The monetary conditions which the directive seeks would, I believe, increase the probabilities that output and employment will continue on a path that is too far below the economy's potential. The gap between output and potential and the consequent lost production, income, and jobs will be greater than can be justified on the basis of the needs of the economy, demand pressures on prices, or the balance of payments. Furthermore, I feel that the directive's content is such as to decrease the likelihood that even those monetary conditions sought by a majority of the Committee will be achieved.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, December 15, 1970, at 9:30 a.m.

Thereupon the meeting adjourned.

Secretary

ATTACHMENT A

November 16, 1970

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its Meeting on November 17, 1970

FIRST PARAGRAPH

The information reviewed at this meeting suggests that real output of goods and services is changing little in the current quarter and that unemployment has increased. Part but not all of the weakness in over-all activity is attributable to the strike in the automobile industry which apparently is now coming to an end. Wage rates generally are continuing to rise at a rapid pace but greater gains in productivity are slowing the increase in unit labor costs. Despite erratic short-run movements in major price measures the general pace of advance in these measures is tending to slow, although not as much as had appeared earlier. Most interest rates declined considerably in the past few weeks, and Federal Reserve discount rates were reduced by one-quarter of a percentage point in the week of November 9. Demands for funds in capital markets have continued heavy, but business loan demands at banks have weakened. The money supply changed little on average in October for the second consecutive month; bank credit also was about unchanged, following a slowing of growth in September. The balance of payments deficit on the liquidity basis was at a lower rate in the third quarter and in October than the very high second-quarter rate, but the deficit on the official settlements basis remained high as banks repaid Euro-dollar liabilities. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions conducive to orderly reduction in the rate of inflation, while encouraging the resumption of sustainable economic growth and the attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead, with allowance for temporary shifts in money and credit demands related to the auto strike. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Alternative B

To implement this policy, the Committee seeks to promote further easing of conditions in credit markets and somewhat greater growth in money than sought earlier, with attendant bank credit expansion, over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives.

Alternative C

To implement this policy, the Committee seeks to promote some easing of conditions in credit markets and moderate growth in money and attendant bank credit expansion over the months ahead, making up in coming months the short-fall from the desired monetary growth path that has developed recently in part as a consequence of the auto strike. System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining bank reserves and money market conditions consistent with those objectives, permitting the Federal funds rate to decline to around the 5 per cent level if necessary and engaging in purchases of Treasury coupon issues insofar as practicable in supplying reserve needs.