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, August 24, 1971, at 9:30 a.m. As indicated below, only a limited number of staff members were in attendance during the first part of the meeting.

PRESENT: Mr. Burns, Chairman
Mr. Hayes, Vice Chairman
Mr. Brimmer
Mr. Clay
Mr. Daane
Mr. Kimbrel
Mr. Maisel
Mr. Mayo
Mr. Mitchell
Mr. Morris
Mr. Robertson
Mr. Sherrill

Messrs. Coldwell, Eastburn, and Swan, Alternate Members of the Federal Open Market Committee

Messrs. Heflin, Francis, and MacLaury, Presidents of the Federal Reserve Banks of Richmond, St. Louis, and Minneapolis, respectively

Mr. Holland, Secretary
Mr. Broida, Deputy Secretary
Mr. Molony, Assistant Secretary
Mr. Hackley, General Counsel
Mr. Partee, Economist[1/]
Mr. Solomon, Associate Economist
Mr. Holmes, Manager, System Open Market Account
Mr. Coombs, Special Manager, System Open Market Account

Mr. MacDonald, First Vice President, Federal Reserve Bank of Cleveland

1/ Left the meeting at the point indicated.

Mr. Katz, Adviser, Division of International Finance, Board of Governors[1]
Messrs. Bryant and Pizer, Associate Advisers, Division of International Finance, Board of Governors

Chairman Burns noted that this was the first meeting of the Committee since the President had announced his new economic program on August 15. In order to facilitate a frank discussion of a number of key issues he had asked that the first part of today's meeting take place in executive session, with staff attendance limited to those persons whose presence was most urgently required. At the outset, it might be helpful to the Committee if he were to comment briefly on various subjects relating to the program--including the events leading up to its development, its main features, some of its economic implications, and the various ways in which it related to the work of the Federal Reserve.

In reviewing the background of the program the Chairman noted that as of late June the Administration had been expressing adamant opposition to such measures as a wage-price review board and mandatory wage-price controls. However, during an early-August press conference the President had indicated that he was prepared to consider the merits of a wage-price review board, or some similar non-mandatory device for moderating inflation, even though he had strong doubts about the usefulness of such devices.

1/ Entered the meeting at the point indicated.

As the members knew, the Chairman continued, the President had made decisions in that area as well as others during the course of a weekend meeting at Camp David, Maryland, immediately preceding his address on August 15. The starting point for the Camp David deliberations was a recognition that the economic situation was unsatisfactory in a number of major respects. First, inflationary pressures were strong and there were widespread expectations that such pressures would continue and perhaps even strengthen further. Secondly, there was large-scale unemployment, and it was feared that the unemployment rate would not decline appreciably in the near term. Third, there had been a rapid deterioration in the balance of trade, and the deficit in the over-all balance of payments had reached staggering proportions. Fourth, there was dissatisfaction in many quarters--particularly business circles--with the rapid proliferation of Government spending. Finally, there was concern about the apparent stagnation of productivity; specifically, about the fact that for the past two or three years the rate of productivity increase had been very low and well below the long-term trend.

The objective of the Camp David meetings, the Chairman observed, was to deal with these various problems as effectively as possible and in an integrated fashion. Although the Committee members

were familiar with the elements of the program developed in the course of the meetings, it might be desirable for him to make a few comments on them. The 90-day wage-price freeze was intended to be a kind of shock therapy, to rid the nation to the extent possible of inflationary expectations and fears. Also, it was expected that the 90-day period would be used to devise a mechanism for curbing wage and price increases over the subsequent period. There was no thought of imposing permanent ceilings on wages and prices, but it was felt that some curbs would be necessary in the transition to a state of general price stability. The cabinet-level Cost of Living Council established by the President had the dual responsibilities of administering the freeze and of developing recommendations for policies to be followed afterward.

The program of tax reductions presented by the President would, of course, require legislation, Chairman Burns remarked. While Congress no doubt would make some changes, it was quite possible that the program would be enacted in a form close to that recommended. Of the three tax proposals, one--the restoration of the investment tax credit--involved a significant innovation in calling for a credit of 10 per cent during the first year and of 5 per cent thereafter. Relative to the 7 per cent rate used when the tax credit was last in effect, a 10 per cent credit obviously would offer greater incentive to businesses to invest in new machinery and equipment.

More importantly, the provision for a larger credit in the first year than later should tend to produce a bunching of investment during that period--a consideration of great importance in the present state of the economy. As the Committee knew, the other two tax proposals were to advance to the beginning of 1972 certain increases in personal exemptions and standard deductions under the individual income tax that were now scheduled for the beginning of 1973; and to repeal the 7 per cent excise tax on automobile sales.

Chairman Burns went on to say that the 10 per cent import surcharge had been instituted under the authority of the Trade Expansion Act of 1962. Under the terms of that legislation the surcharge applied only to dutiable items, and for some items the added duty was less than 10 per cent; thus, for new automobiles, which already carried a 3-1/2 per cent duty, the surcharge was 6-1/2 per cent.

With respect to the various expenditure reductions contemplated, the Chairman continued, it was estimated that budgeted outlays in the 1972 fiscal year would be reduced by $1.3 billion under the six-month deferral of the Federal pay raise now scheduled for January 1, 1972; and by an additional $0.5 billion under the 5 per cent cut in Federal employment to be accomplished within the year. Other savings in planned outlays would be made by deferring the effective dates of welfare reform by one year, of general revenue sharing by three months, and of special revenue sharing for urban

development and rural transportation by six months and one year, respectively. With additional cuts in various areas, planned expenditures for fiscal 1972 would be reduced by a total of about $4.6 billion.

The final element of the program, Chairman Burns observed, was the suspension of the convertibility into gold of foreign official holdings of dollars. That element was, of course, of special interest to the Committee.

The Chairman said one broad purpose of the over-all program was to restore confidence at home, and if early indications were to be trusted, it appeared that that objective was likely to be achieved. On the other hand, the announcement of the program had raised questions, doubts, and uncertainties abroad. Obviously, the international problems had not yet been resolved, and the Government--including the Federal Reserve--would have to concern itself with those problems in the days ahead.

Since the staff would be discussing the economic implications of the program in its reports today, Chairman Burns continued, he would make only a few observations. First, he thought the fiscal implications were not generally understood. In terms of the arithmetic of the proposals, as he had noted earlier, the various budgetary actions contemplated involved a reduction in planned outlays for fiscal 1972 of $4.6 billion. It was estimated that the three types

of tax reductions would lower receipts by $6.2 billion and that the import surcharge would bring in $2.1 billion, so that there should be a net reduction in Government receipts of $4.1 billion. Thus, the anticipated deficit in fiscal 1972 would be reduced by about $0.5 billion. Those figures had been widely interpreted to mean that the program would not provide stimulation to the domestic economy. That, he thought, was a misconception.

For one thing, the Chairman observed, a number of the budgetary proposals were in fact not likely to result in any actual reductions in outlays. A case in point was the deferral for three months of the effective date of the proposed legislation for general revenue sharing. Since it had been highly unlikely in any event that that legislation would be enacted by the effective date originally proposed--if at all--the change in the date would have no real effect on expenditures. The same was true of various other changes included in the calculations. As of the moment, he was inclined to think that the postponement of the Federal pay increase and the reduction in Federal employment would involve a meaningful reduction in outlays, but that most of the other budgetary changes listed would not.

Secondly, the Chairman remarked, the purpose of the investment tax credit was not simply to provide businesses with additional funds for spending on new equipment. Rather--and this was of

key importance--the credit was intended to provide an incentive for businesses to make much larger increases in outlays, drawing not only on the tax savings but also on accumulated funds and on credit sources to finance them. It was by that means that the desired effect would come if it came at all.

In short, Chairman Burns observed, the simple arithmetic of the proposed fiscal actions did not tell the story of the degree of fiscal stimulus implicit in the new economic program. In his judgment the program implied a great deal of stimulus.

There was one other point he would like to make about economic implications, the Chairman said. In his address the President had indicated that both the suspension of the convertibility of the dollar and the imposition of the import surcharge were temporary actions, and that there were problems with respect to the international monetary system that had to be worked out. Similarly, the wage-price freeze was a temporary action, to remain in effect for 90 days while mechanisms were developed to achieve continued stability after that period. Thus, the new economic program was still in an early stage, and the form which it would eventually take was not yet clear. The program would be under development in the period ahead, and the Federal Reserve might have some influence on its ultimate shape.

Finally, Chairman Burns remarked, he would say a few words about how the new economic program related to the work of the

Federal Reserve System. As the Committee members knew, he had been named as adviser to the Cost of Living Council. The possibility of his being a member of the Council had been discussed, but in light of his association with the Federal Reserve he had thought it would be more appropriate to serve as adviser and the President had readily accepted that suggestion. Mr. Partee of the Board's staff was serving as his deputy and was accompanying him to meetings of the Council.

The Federal Reserve was, of course, deeply concerned with the subject of interest rates, the Chairman remarked. Questions were being raised in many quarters as to why the 90-day freeze had not been extended to cover interest rates--in effect, why financial institutions had not been asked to join in what was intended to be a common sacrifice. During the White House meeting last week with the bipartisan leadership of the Congress, which he had attended, a number of the legislators had indicated that they were troubled by the omission; and the matter was certain to be discussed in the Congress when it reconvened in early September.

The possibility of including interest rates in the freeze had been considered at Camp David, Chairman Burns noted, and the decision not to do so had been made deliberately. In his judgment that was the proper decision. Insofar as the price-wage freeze tended to curb inflationary expectations it could be expected to

release powerful forces tending to reduce interest rates, since recent rate levels clearly included a substantial inflation premium. The decline in market interest rates that occurred following the announcement of the program indicated that such forces were indeed at work. So long as interest rates in general remained below the levels that had prevailed before the President's address he did not think much pressure would build up for including them in the freeze. The situation would be different, of course, if rates were to move back up above those levels.

As the members knew, the Chairman observed, late last week Secretary Connally had addressed a letter to banks and savings institutions in which he noted that the President believed lenders would voluntarily keep interest rates low; and that he (the Secretary) not only hoped but expected that lenders would look beyond short-run profits when they set rates and would consider the broad public implications of their policies. Also, he understood that today the Federal Home Loan Bank Board would be announcing a variety of measures designed to stabilize rates on mortgages and to make more money available for mortgage lending. There was some question in his mind about the desirability of those measures, which Chairman Martin of the FHLBB had described to him in a telephone conversation late yesterday, but he would not take the time to go into the matter now. As to the role of the Federal Reserve, he personally was not

eager to have it devote its efforts to pressing interest rates down. The Committee would, of course, be discussing the type of monetary policy that would be appropriate later in its meeting today.

Continuing, the Chairman remarked that the System also was affected by the new economic program in that both the Board and the Reserve Banks would want to comply with the spirit of the Government's policy with respect to the 5 per cent reduction in the number of employees. The discussions at Camp David had proceeded on the assumption that the desired reduction could be accomplished by attrition and that it would not be necessary to discharge anyone. He personally did not have the facts required to determine whether or not such an assumption was justified. He should add that the base from which the reduction was to be measured was still unclear; it might be defined in terms of either the actual or the authorized number of employees, and as of some specific date such as August 13 or in some period such as the 30 days preceding that date.

The Chairman observed that in due course the Office of Management and Budget presumably would be issuing guidelines on the subject to departments and agencies in the Executive Branch. The Reserve Banks would be informed of the nature of such guidelines as soon as they were available. In the interim it might be best for

the System to proceed very cautiously in filling vacancies, so that the normal process of attrition could work.

Another way in which the Federal Reserve was involved in the program, the Chairman said, was that it would participate in the development of the new international monetary order. While some might have doubts as to whether it had been necessary to suspend the convertibility of dollars into gold in view of the other strong measures included in the program, there would be little point in debating that matter at this point; convertibility had been suspended and the old order was gone. The need now was to rebuild, and to do so quickly. For example, if the temporary import surcharge were permitted to remain in place very long it might come to be viewed as a permanent feature of U.S. commercial policy and tax policy. In that event, restrictions on trade would surely be imposed by nations all over the world, and foreign trade would tend to wither. Prompt action was required to minimize the risk of trade wars, currency wars, and the general multiplication of restrictions.

Finally, Chairman Burns observed, the Committee would have to discuss the implications of the new economic program for monetary and credit policy, as he had already suggested. He asked whether members had any comments or questions on the program that they would like to raise at this point.

Mr. Mayo remarked that he not only considered the fiscal program as formulated by the President to be stimulative but he also thought it was likely that the tendency of Congress would be to make it even more stimulative. In particular, he would expect Congress to enact legislation involving a larger cut in personal income taxes than the President had recommended.

As to the contemplated 5 per cent reduction in Federal employment, Mr. Mayo recalled that in past periods of retrenchment the budgets of agencies carrying out the regular "housekeeping" functions of Government, such as the Treasury and the General Services Administration, had been reduced less than the Government-wide average, and the budgets of agencies responsible for special programs had been cut more than the average. The objective of that approach was, of course, to disturb the normal functioning of the Government as little as possible. While he was in complete agreement with the Chairman's observation that the System would want to abide by the spirit of the employment cutback, he thought it should be recognized that the Reserve Banks, like the Treasury, were engaged primarily in housekeeping functions.

Mr. Morris remarked that the Reserve Banks obviously would need guidance from the Board in carrying out any reduction in employment. He noted that the Banks were now staffing to take on new functions in the check clearing area as well as others. He thought

it would be necessary to consider the size of the work force devoted to individual programs at each Bank as well as the over-all level of Bank employment.

Mr. Hayes concurred with Mr. Morris' observation. He added that most of the recent expansion in Reserve Bank employment had been in connection with new programs.

Mr. Heflin commented that the staff's GNP projections seemed to him to be based on a rather optimistic view of the probable success of the new economic program. He asked whether Chairman Burns thought their optimism was warranted.

The Chairman replied that it was much too early to make such an appraisal. He might note that the Cost of Living Council was showing a strong disinclination to make exceptions to the wage-price freeze, and he expecred them to maintain that attitude. Also, the leaders of both parties in the Congress had given assurances to the President that his legislative proposals would receive prompt consideration, and in his (Chairman Burns') judgment the chances were quite good that the tax legislation would be enacted at a rather early date. In that connection, he should mention that he agreed with Mr. Mayo that the legislation finally enacted would provide for greater reductions in personal income taxes than the President had recommended. Apart from such observations, it was difficult at this time to do more than guess at the likely outcome and express one's hopes.

Mr. Eastburn noted that in its letter of July 29, 1971, the Board had requested each Reserve Bank to set up a cost control program and to furnish certain information about the program by September 1. He asked whether the Board would now prefer to have the Banks delay their replies beyond that date so that they could incorporate information about employment reductions to be achieved in line with the President's new economic program.

Chairman Burns said he personally thought it would be best for the Reserve Banks to reply to the Board's letter by the date originally suggested and stand ready to take further action when guidelines were developed for employment reductions. However, he would like to have Mr. Sherrill's views on the question.

Mr. Sherrill concurred with the Chairman's statement.

In response to a further question by Mr. Eastburn, Chairman Burns said the Reserve Banks would be given an opportunity to react to any proposals the Board might develop for reductions in System employment.

Mr. Hayes asked whether the Board would prefer to have the Reserve Banks respond to the July 29 letter along the lines they had been planning before the President's address or to try to take account of the new program as best they could at this time.

Chairman Burns said he would be prepared to leave that question to the judgment of the individual Reserve Banks.

Mr. Sherrill added that while it would be desirable to take the new program into consideration, very little time was available for that purpose. Accordingly, he assumed the Reserve Bank responses would be directed primarily to the Board's earlier letter.

The Chairman then noted that immediately after the President's address Mr. Daane had left for Europe with Under Secretary Volcker to discuss the international aspects of the program with certain foreign officials. He invited Mr. Daane to report on that trip.

Mr. Daane observed that Under Secretary Volcker and he had met in London on Monday, August 16, with officials of the central banks and finance ministries of England, Germany, Italy, and France, and with the London representatives of the Japanese monetary authorities. In Paris on the following day they had talked with the French Finance Minister, and separately with the President of the Swiss National Bank and the Secretary-General of the Organization for Economic Cooperation and Development. Also, they had held lengthy telephone conversations with the President of the Netherlands Bank.

Mr. Daane said he would attempt to convey only the broad thrust of those discussions and not take the time to describe the detailed views of individuals. In general, the Europeans were surprised and shocked by the President's announcements. They had always recognized in principle that the United States could suspend the convertibility of the dollar, but they had not expected that

action to be taken suddenly at this time. Accordingly, they were not prepared to offer considered reactions in the course of the discussions.

The Europeans appeared to have two main concerns, Mr. Daane continued. One, expressed most vocally by the Germans but also by others, related to the import surcharge, and involved such questions as how it would affect their exports, how long it was likely to remain in place, and whether it augured a movement toward protectionism on both sides. The attitude of the Europeans in these initial discussions suggested that for the present they would be trying to avoid retaliatory actions, but that pressures for such actions would mount. Mr. Volcker had indicated that, as the President had said in his address, the surcharge was a temporary measure and would be removed when the necessary international adjustments had been made--not simply in rate alignments but also in trade and burden-sharing policies.

The Europeans' second main concern, Mr. Daane said, related to the question of how they could reopen their foreign exchange markets on a credible basis. Mr. Volcker emphasized that he had not come to Europe to make any particular proposals with respect to exchange rate realignments or to launch negotiations on that subject; the purpose of the visit was simply to explain the background and rationale of the President's program. He nevertheless made it clear that the United States considered it necessary to reverse the deterioration in its trade balance and to restore

equilibrium in its over-all balance of payments. In fact, he suggested that a payments surplus for several years would be desirable, and that once adjustments had been made that pointed convincingly toward such a surplus the United States would be prepared to discontinue the surcharge. He stressed that the legal basis for the surcharge--that of Executive action--had been chosen deliberately to permit flexibility.

Questions also were raised about the implications of the President's references to urgently needed reforms in the international monetary system, Mr. Daane observed. The U.S. representatives noted that some possible changes had already been discussed at length in international meetings and in the press, including wider margins and provision for transitional floats. They indicated that the United States did not have a blueprint of the kinds of reforms needed, but thought it would be desirable to take advantage of the opportunity provided by the present situation to work out agreements in that area. In that connection there was some discussion of the procedural question--specifically, of whether it would be best to hold an early meeting of the Ministers and Governors of the Group of Ten or to employ some other forum. The U.S. representatives noted that this country would not favor an international conference along the lines of Bretton Woods, nor would it consider it desirable to turn the matter over to the Executive Directors of the International Monetary Fund as a group. While a meeting of the G-10 countries was seen as a possibility, some disadvantages were

noted. Also mentioned was a possible meeting involving Secretary Connally and the Finance Ministers of perhaps five major countries, but that alternative was not pursued.

In general, Mr. Daane remarked, the Europeans considered it desirable to undertake the needed discussions promptly. Indeed, it was suggested that a G-10 meeting might be held during the weekend of August 21. The prevailing view, however, was that so early a date would not provide adequate time for the individual countries involved to develop their own positions. There was considerable concern that a lengthy period of floating exchange rates would lead to a new wave of protectionism, in which the U.S. import surcharge would no longer be viewed as temporary and would be countered by restrictive measures around the world. Thus, the Europeans felt that the earlier it proved possible to return to a stable situation the better it would be.

Chairman Burns commented that the suspension of convertibility had set forces in motion which greatly weakened the case for direct controls on capital outflows such as the voluntary foreign credit restraint program. There had been a good deal of discussion at the Camp David meetings of possible action with respect to the VFCR and the foreign direct investment program of the Commerce Department. While the decision had been to take no action for the time being, the general feeling was that those programs probably should be discontinued in the not-too-distant future. Even apart

from the new economic program, there had been a problem with respect to the VFCR as a result of the recent enactment of legislation exempting export credits. The Chairman invited Mr. Brimmer to comment on the subject.

Mr. Brimmer noted that the legislation the Chairman had mentioned was signed into law by the President on August 17. Under the terms of the law, the Federal Reserve had up to 90 days from that date to work out whatever modifications in the program were needed in light of the export credit exemption, and participating banks had been asked to comply with the existing program for the time being. A conference at the Board of the VFCR officers of the Reserve Banks to discuss possible revisions in the program had been scheduled for last week, but he had canceled the meeting because it was clear that some guidance from the Treasury was needed. The Treasury had now indicated that it might prove desirable to discontinue the programs completely in connection with a possible general realignment of exchange rates, and accordingly that it would prefer to have the matter held in abeyance for the moment. He might also note that yesterday a request for a meeting had been received from the Bankers Association for Foreign Trade. The reply he had drafted suggested that a meeting at this time might not prove productive. The Reserve Banks would be advised of the final response that was made.

In his judgment, Mr. Brimmer continued, if the United States discontinued its control programs completely in connection with a

realignment of exchange rates, capital outflows would be substantially larger than otherwise. The trade surplus needed for balance of payments equilibrium would have to be correspondingly larger--perhaps by an amount on the order of $1 billion or $2 billion.

In a concluding observation Mr. Brimmer noted that a telegram had been sent yesterday to the Reserve Bank VFCR officers, requesting information on the extent to which Japanese banks were making calls on existing credit lines with U.S. banks. There apparently had been a substantial outflow to Japan by that route in the last week or so. The Treasury Department also was seeking information on the subject from the American Embassy in Tokyo.

Mr. Hayes referred to Mr. Brimmer's comment that the Treasury might consider it desirable to discontinue the present control programs in connection with a realignment of exchange rates. In his (Mr. Hayes') judgment such an action might give other countries the impression that the United States was completely unconcerned with the volume of capital outflows, and thus might jeopardize the objective of cooperative action in developing a new international monetary system.

Chairman Burns said he had held that view at the time of the Camp David meetings and still did so. Nevertheless, there was a certain logic in the argument that it was desirable to discontinue controls once exchange rates were cut free from the old fixed parities.

Mr. Robertson added that if the controls were ever to be discontinued it would be necessary to take the opportunity to do so when it was offered. In his judgment the present situation presented an excellent opportunity.

Mr. Sherrill observed that the main risk in the present international situation seemed to be that a long period of floating rates might eventually culminate in a contraction of international trade. He asked whether the staff thought that major industrial nations of the world, such as Germany, Japan, and France, were likely to view such a risk seriously enough to be prepared to make the compromises that might be necessary to move back to a stable situation.

Mr. Solomon commented that his first reaction was to question the assumption Mr. Sherrill was making; it was not clear to him that international trade would necessarily suffer during an extended period of floating rates. While he would not advocate moving toward floating rates as a permanent state, he noted that the Canadian dollar had been floating since May 1970 and the German mark and Dutch guilder since early May 1971, without apparent damage to trade. It was worth noting that floating rates did not necessarily imply erratically moving rates.

Mr. Daane remarked that there nevertheless appeared to be a definite risk at present that floating rates would eventually result in protectionist actions that would damage trade. The clearest

example was Germany, where exporters were now faced with both a *de facto* revaluation of the mark on the order of 8 per cent and a 10 per cent U.S. import surcharge. As a result of that situation the German authorities were likely to find themselves under tremendous pressure to adopt some protectionist measures.

Chairman Burns added that the risks involved also could be illustrated by the domestic situation. The import surcharge provided obvious benefits to American firms subject to foreign competition, and it was likely that the longer they enjoyed those benefits the more actively they would oppose the discontinuance of the surcharge. His response to Mr. Sherrill's question would be that all of the affected countries no doubt were eager to see a new monetary order developed before trade barriers multiplied and became permanent features of policy. However, that did not necessarily mean that new international agreements would be reached quickly, since individual countries might hold strongly to particular positions that were not acceptable to other countries.

Mr. Brimmer expressed the view that the negotiations might prove more difficult than would appear at first glance. Consequently, the period during which exchange rates floated and the import surcharge remained in place might prove much longer than desirable. As a result of the emergence of large multinational corporations, the structure of trade had changed a great deal since Bretton Woods. Both those corporations and the monetary authorities of major

countries might well learn to manage their international financial transactions without undue difficulty in a world of fluctuating rates. Indeed, some seemed to have learned how to do so already. On the other hand, the developing countries might not be able to cope with such fluctuating rates, and their trade probably would be affected adversely.

Mr. MacLaury remarked that it would be difficult to determine the appropriate levels of foreign exchange rates so long as the capital control programs remained in force, and he would question the desirability of attempting to do so.

Mr. Mitchell observed that in his judgment the public interest would not be served by the removal of all capital controls, since efforts to limit capital outflows by means of monetary policy could result in the stagnation of the domestic economy. Some means should be devised to limit such outflows directly; his preference would be a measure along the lines of the interest equalization tax.

Mr. Brimmer agreed that there would be a bigger role for market-oriented controls, such as the IET, than for mechanisms such as the VFCR under the new international monetary arrangements that would be developed in due course.

Mr. Hayes commented that the complete elimination of controls would raise serious questions about international interest

rate relationships and the ability of individual countries to pursue independent monetary policies.

Chairman Burns then noted that in the period since the previous meeting Committee members had approved increases in two System swap lines and conforming amendments to paragraph 2 of the authorization for System foreign currency operations. An increase in the line with the National Bank of Belgium, from $500 million to $600 million, had been approved on August 9, effective on that date; and an increase in the line with the Swiss National Bank, from $600 million to $1 billion, had been approved on August 11, effective August 12. Those actions were subject to ratification today. The Chairman asked Mr. Coombs to comment.

Mr. Coombs observed that before recommending the increases in question to the Committee he had discussed them with the Treasury and had determined that the Treasury considered them to be in the national interest. As noted in Mr. Broida's memorandum to the Committee of August 23, 1971,[1/] at the request of the Belgian authorities the increase in the swap line with the Belgian Bank actually had been effectuated on August 12. Accordingly, he

1/ A copy of this memorandum, entitled "Effective date of Belgian swap line increase," has been placed in the Committee's files.

recommended that in the process of ratification the Committee make a corresponding amendment to the effective date of the increase in question.

By unamimous vote, the Committee ratified the actions of members on August 9 and 11, 1971, respectively, approving increases in the Federal Reserve swap lines with the National Bank of Belgium from $500 million to $600 million and with the Swiss National Bank from $600 million to $1 billion, and the conforming amendments to paragraph 2 of the authorization for System foreign currency operations, with these several actions effective on August 12, 1971.

As a result of these actions, paragraph 2 of the authorization for System foreign currency operations was amended, effective August 12, 1971, to read as follows:

The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Austrian National Bank	200
National Bank of Belgium	600
Bank of Canada	1,000
National Bank of Denmark	200
Bank of England	2,000
Bank of France	1,000
German Federal Bank	1,000

Foreign bank	Amount of arrangement (millions of dollars equivalent)
Bank of Italy	1,250
Bank of Japan	1,000
Bank of Mexico	130
Netherlands Bank	300
Bank of Norway	200
Bank of Sweden	250
Swiss National Bank	1,000
Bank for International Settlements:	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,000

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 July 27 through August 18, 1971, and a supplemental report covering the period August 19 through 23, 1971. Copies of these reports have been placed in the files of the Committee.

In comments supplementing the written reports, Mr. Coombs observed that the decision to close the gold window had demolished with one stroke the Bretton Woods exchange rate system. Foreign governments and central banks were immediately confronted with the problem of how to operate their exchange markets without a convertible dollar or any alternative intervention currency. They had no choice but to close their exchange markets, in the hope of reaching quick agreement in the Common Market and closely associated countries on a coordinated exchange market policy.

Those negotiations had failed, and the exchange markets were reopened yesterday on an every-country-for-itself basis.

The market atmosphere yesterday and this morning could hardly have been worse, Mr. Coombs continued. The markets had construed the developments of the last week or so as a breakdown of international cooperation; first, between the United States and its major trading partners, and secondly, within the European Common Market. There was grave apprehension of deepening political conflict, spreading protectionism, and exchange controls; and he thought such fears would tend increasingly to have a paralyzing effect on trade and investment. Meanwhile, market judgments as to whether to buy or sell at certain rates had to be made and foreign exchange traders were confronted with some truly bewildering dilemmas. The market had been deluged with assertions that the dollar was overvalued and should be devalued, but the devaluation target--whether 5, 10, or 15 per cent--remained entirely obscure. Just for example, should the devaluation sought be sufficient to permit complete removal of the interest equalization tax, the OFDI program, and the voluntary foreign credit restraint program? Statements of certain ranking U.S. officials had already conveyed to the market the view that that might be the objective. Alternatively, did the devaluation argument imply removal of the 10 per cent import surcharge immediately after a general

realignment of exchange parities, or its continuation until discriminatory trade practices abroad were at last corrected and Europe had taken up a larger share of the defense burden? Even if the exchange markets had some semblance of an answer to those crucial questions, they would still be confronted with the question of just which currencies were the undervalued counterparts of an overvalued dollar. The Japanese yen was generally regarded as falling in that category, but once past the yen the question quickly elicited sharply conflicting points of view at both official and market levels.

With the exception of Germany, Mr. Coombs remarked, the European governments so far were sternly resisting any revaluation of their currencies on the grounds that their current account positions were not strong enough to withstand any important sacrifice of their competitive trading strength. As some observers had expected, they therefore had taken action to fend off speculative and other capital inflows in the hope that their payments and receipts on current account would stay roughly in balance at current exchange rate levels. Whether or not those capital controls would remain effective over any period of time remained to be seen. The French experiment with a two-tier commercial and financial dollar would be closely watched, and if it proved successful it might quickly spread to other Common Market countries.

In any event, the clear distinction being made by European governments between exchange rates appropriate to current account transactions and exchange rates appropriate not only to trade but also to an unfettered outflow of capital from the United States seemed likely to be a central issue in any negotiations on parity realignments.

Meanwhile, Mr. Coombs said, the dollar was floating on the European exchanges with some buoyancy, perhaps reflecting changes in expectations generated by the wage-price freeze and related domestic measures. The premium on the mark had come down from the 7 per cent reached on the Friday before closure of the gold window to 5.7 per cent yesterday, but it had moved up again this morning to 7 per cent. Similarly, the premium on the guilder had fallen from 4.5 per cent to 3.2 per cent yesterday, but it had been pulled up by the mark to 4 per cent today. Sterling was trading at a premium of no more than 1 per cent above its previous upper limit; the Belgian franc commercial rate at a premium of no more than 2.5 per cent; and the lira at 1.0 per cent. Yesterday, the Bank of France did not have to take in any dollars on commercial transactions. All of those rates were being produced, however, in extremely thin markets as traders on both sides of the Atlantic remained extremely cautious and fearful

of any exposure. Medium-sized transactions of $5 million or $10 million, which had formerly passed through the market without causing a ripple, were now being broken down into a series of bite-size transactions of $250,000 or so in order to avoid driving rates against the buyer.

As the market accumulated more experience with the floating rate system, Mr. Coombs continued, volume should increase and a semblance of orderly trading might reemerge. On the other hand, the market did not yet seem to realize that the closure of the gold window had brought about a massive destruction of international liquidity. The swap lines were frozen; so was the IMF; the status of the SDR's was highly questionable; and no foreign central bank would sell gold at $35 an ounce except in the most dire emergency. All that remained of international liquidity available for use at the moment was inconvertible dollars, of which there was no shortage of supply; rather, there was an acute shortage of official buyers. The likely consequence was that, if and when one of the major European countries got into trouble again, it would not waste much time in defending its currency; instead, it would allow the market to drive down the rate and so put pressure on its neighbors. That was how the competitive depreciations of the 1930's had emerged and brought about the proliferation of defensive measures in the form of trade and

capital controls. The fear of such developments was very much in the minds of all of the European governments, and it presumably was reinforcing their resistance to revaluing, which would necessarily increase their vulnerability to future misfortune.

Mr. Coombs went on to say that in his judgment the question raised earlier by Mr. Sherrill was best answered not in the context of the currencies that happened to be floating at the moment but rather in terms of a floating currency that was in trouble--as had been the case, for example, with respect to the Canadian dollar in 1962. Such a situation could arise from one month to the next in a system of generally floating rates. In his judgment, floating rates were a fair-weather device; one could not make a realistic appraisal of such a system on the basis of the recent performance of the Canadian dollar and the German mark.

In response to a question by Mr. Heflin, Mr. Coombs said he thought foreign central banks would do their best to avoid taking in dollars under present circumstances.

Chairman Burns asked whether Mr. Coombs believed that individual foreign countries were likely to try to peg their rates at some new level prior to a general realignment.

Mr. Coombs replied that he would expect individual countries to be most reluctant to peg their rates even temporarily.

For one thing, they probably would feel that they had no realistic basis for determining the appropriate new parity. For another, they would be faced with the fact that any dollars they acquired in defending the new parity were likely to be inconvertible.

Mr. Heflin commented that it might be useful for the United States to undertake some contingency planning at this point about possible means for absorbing dollars under any new arrangements that were developed. Presumably responsibility for such planning lay with the Treasury.

Mr. Coombs remarked that it might be feasible to work out arrangements for funding foreign dollar inflows that had occurred before the suspension of convertibility, perhaps along the lines of the operation arranged with the Germans in late June. The more significant question, in his judgment, was disposition foreign central banks would be able to make of future dollar inflows.

Mr. Sherrill asked whether Mr. Coombs saw any implication in the fact that the dollar was still convertible into American goods.

Mr. Coombs replied that the same could be said about any currency. The key fact, as he saw it, was that the dollar had been rejected as a reserve currency by countries that had floated their exchange rates, and that the dollar's new status had been confirmed by the closure of the gold window. The problem to be faced now was whether any effective substitute could be devised.

By unanimous vote, the System open market transactions in foreign currencies during the period July 27 through August 23, 1971, were approved, ratified, and confirmed.

Mr. Coombs noted that a $35 million System drawing on the National Bank of Belgium would reach the end of its second three-month term on September 10. He recommended renewal of that drawing, if agreeable to the Belgians. The possibility could not be ruled out that the Belgians would ask instead that the drawing be paid off in reserve assets. However, there had been no suggestion thus far that they planned to make such a request.

Mr. Maisel asked whether it would be possible for the System to acquire in the market the Belgian francs needed to repay the drawing if the Belgians preferred not to renew it.

Mr. Coombs replied that an effort by the System to acquire so large a volume of francs in the market would drive the exchange rate sharply upward. That would be considered a hostile act by the Belgians, who could point out that at the time the drawing was first made they had refrained from asking the United States to convert the dollars involved into reserve assets. If the Belgians declined to renew the drawing at this point the System would be faced with the kind of situation contemplated in the letter of July 23, 1968, from Secretary Fowler to Chairman Martin,

in which the Secretary had indicated that the Treasury would stand ready to use the basic reserve resources of the United States to provide the Federal Reserve with the foreign currencies needed to repay drawings when market flows had not reversed themselves within an appropriate period.

After further discussion it was agreed that it would be desirable to renew the drawing in question if that was agreeable to the Belgians.

By unanimous vote, renewal of a $35 million System drawing on the National Bank of Belgium maturing September 10, 1971, was authorized.

Mr. Coombs then observed that on the Tuesday before the decision to close the gold window, the Swiss National Bank had indicated that it desired to cover most of its uncovered dollars and also all new inflows.[1/] Accordingly, they had asked the Federal Reserve to draw the full $600 million still available on its swap line with the BIS and to increase its swap line with the Swiss National Bank from $600 million to $1 billion. At the same time, the Swiss asked the System to explore possibilities of further cover in the form of SDR's or Treasury bonds denominated in Swiss francs.

As the Committee knew, Mr. Coombs continued, the two Federal Reserve actions requested had been taken. By Thursday, August 12,

1/ Mr. Katz was present during the discussion of this matter.

following further inflows to Zurich, it became necessary to draw the $400 million increase in the swap line with the Swiss National Bank, thus fully exhausting the System's Swiss franc lines. That evening he had raised with the Treasury the question of the response that should be made to any further Swiss requests for cover on Friday. Secretary Connally had authorized him to advise the Swiss that the United States would cover Friday's inflow. That decision left in abeyance the Swiss request for cover of other uncovered dollars already on their books, which amounted to nearly $700 million.

Mr. Coombs observed that the commitment to cover Friday's inflow, amounting to $333 million, was made Friday morning; and it was confirmed by Mr. Volcker in subsequent conversations with the Swiss. Later he had spoken with Mr. Volcker regarding a possible Treasury issue of a Swiss franc bond and initially that course of action had seemed agreeable. Yesterday, however, he had been advised that the Treasury now thought it would be preferable for the System to provide the cover by increasing its swap line with the Swiss National Bank by $333 million.

In response to the Chairman's request for his recommendation, Mr. Coombs said that it was the Treasury's present judgment that the course proposed was in the national interest. Such a judgment

was, of course, a powerful argument in favor of affirmative action and consequently he would recommend that such action be approved. He would hope, however, that before the action was implemented discussions would be held with the Treasury to insure that all of the relevant factors had been taken into account.

After discussing the legal and financial aspects of the proposal and the risks involved, the Committee agreed that the action should be taken if, following further discussions, Chairman Burns concurred in the Treasury's current view that such action was in the national interest.

> By unanimous vote, the Committee approved an increase in the Federal Reserve swap line with the Swiss National Bank from $1 billion to $1,333 million, and the conforming amendment to paragraph 2 of the authorization for System foreign currency operations, to become effective if and when Chairman Burns determined that such action was in the national interest.

> Secretary's Note: After subsequent discussions among Federal Reserve, Treasury, and Swiss National Bank officials, it was determined that alternative means for accomplishing the objective in view would be preferable. Accordingly, the increase in the swap line was not effectuated.

Mr. Bryant then presented a statement setting forth the current thinking of the Board's staff on certain key questions of

concern to government officials in the United States and abroad. These questions were: how the immediate period of floating exchange rates might be managed; whether international agreement could be reached soon on a realignment of parities; and what the nature of any such agreed realignment should be. He also listed a number of major issues that would require consideration in the period ahead.

The Committee then engaged in a discussion of Mr. Bryant's statement. During the course of the discussion Chairman Burns said he wanted to stress the sensitive nature of many of the statements made during this morning's executive session and the need for great care on the part of all participants to safeguard the confidentiality of the proceedings.

The Chairman also noted that discussions were now under way within the Government with respect to the positions the United States should take in the forthcoming international negotiations. Both he and Mr. Daane were participating actively in those discussions, and they would be grateful for any guidance Committee members might have to offer. Because basic decisions might be taken in the near future, it would be particularly helpful if the members would act promptly in transmitting any observations they cared to make.

The meeting then recessed and reconvened at 2:25 p.m. In attendance were those present at the morning session as well as the following:

Mr. Bernard, Assistant Secretary
Messrs. Axilrod, Eisenmenger, Garvy, Scheld, Taylor, and Tow, Associate Economists

Mr. Altmann, Assistant Secretary, Office of the Secretary, Board of Governors
Mr. Cardon, Assistant to the Board of Governors
Mr. Coyne, Special Assistant to the Board of Governors
Mr. O'Connell, General Counsel, Board of Governors
Mr. Williams, Adviser, Division of Research and Statistics, Board of Governors
Messrs. Keir and Pierce, Associate Advisers, Division of Research and Statistics, Board of Governors
Mr. Baker, Economist, Government Finance Section, Division of Research and Statistics, 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. Craven, Senior Vice President, Federal Reserve Bank of San Francisco
Messrs. Sternlight, Willes, Hocter, Snellings, Jordan, and Green, Vice Presidents, Federal Reserve Banks of New York, Philadelphia, Cleveland, Richmond, St. Louis, and Dallas, respectively
Mr. Kareken, Economic Adviser, Federal Reserve Bank of Minneapolis
Mr. Meek, Assistant Vice President, Federal Reserve Bank of New York

By unanimous vote, the minutes of actions taken at the meeting of the Federal Open Market Committee on July 27, 1971, were approved.

The memorandum of discussion for the meeting of the Federal Open Market Committee held on July 27, 1971, was accepted.

Before this meeting there had been distributed to the members of the Committee a report from the Manager of the System Open Market Account covering domestic open market operations for the period July 27 through August 18, 1971, and a supplemental report covering the period August 19 through 23, 1971. Copies of both reports have been placed in the files of the Committee.

In supplementation of the written reports, Mr. Holmes commented as follows:

> The President's new economic program was enthusiastically received by the financial markets and interest rates moved sharply lower over the past week. There were at least three closely related factors behind the rate decline: First, a deep-rooted gratification that the Administration had at long last come up with a determined program of action; second, the squeezing of some of the inflation premium out of interest rates--particularly in the longer maturities--that had been built in during the past year or so; third, a change from expectations that monetary policy would be tightening over the remainder of the year to expectations of neutrality or of some easing in the months ahead. Technical considerations also favored a decline in interest rates, with positions of Government securities dealers relatively light in the face of strong foreign demand and a moderate corporate calendar.
>
> An air of caution was apparent, however. Like others, dealers were not sure how effective the freeze would be. They posed questions about what was going to happen after the 90-day freeze period was over, and some were concerned about the eventual resolution of the foreign exchange situation. All in all, however, the market reaction can only be described as very positive indeed.

Interest rate movements have been described in detail in the written reports, with declines ranging up to 3/4 of a percentage point or more. Some rates--particularly Treasury bill rates--may have moved more than can be sustained, and some backing and filling is likely as events unfold. Some of this was evident in yesterday's Treasury bill auction where average rates of 4.75 per cent and 4.86 per cent were established for the new three- and six-month bills, respectively. While these levels were 20 to 25 basis points above the lows reached a few days earlier, they were 81 and 97 basis points below the rates established in the auction just prior to the last Committee meeting. With the change in interest rate expectations, the spread between three- and six-month bill rates has narrowed significantly since the President's economic message.

Open market operations over the period were designed to promote more moderate growth of the aggregates by supplying reserves rather reluctantly. The Treasury's August refunding was a factor requiring steady money market conditions early in the period, but as soon as even-keel considerations became less of a constraint, the funds rate was permitted to move to the upper portion of the 5-3/8 to 5-3/4 per cent range. With August estimates of the aggregates continuing strong, no change was made in this approach after the President's message, although Federal funds have been trading at 5-1/2 per cent for the past few days. Late in the period, operations had to be adapted flexibly to the huge investment orders the Desk received from foreign central banks at a time when dealer positions were only moderate and dealers were reluctant sellers. All in all, in the 10-day period ending last Friday, foreign central banks had over $6 billion (gross) to invest, reflecting the frantic activity in the foreign exchange markets. It was, of course, impossible to find Treasury bills in the market in this amount, and the Treasury had to issue $4 billion in special certificates to foreign central banks. Another $630 million was issued yesterday.

The Treasury's cash position has been bolstered unexpectedly by these transactions. The Treasury, quite naturally, has not been particularly happy with this windfall, since it represented cash that it did not need at this particular time and carries the risk of an untimely cash drain at some point in the future if international speculative flows are reversed. We will

be trying to work out some means of phasing out this massive volume of special certificates in an orderly fashion. Since the Treasury, quite rightly, does not feel that it can count on these funds, it is planning to go ahead with a cash financing, perhaps later this week. While nothing has been decided as yet, there is a possibility that the Treasury may offer an intermediate-term note.

Looking ahead, the blue book[1/] has made a courageous effort to predict what the new economic program will mean for growth rates of the monetary and credit aggregates. There is no question, as the blue book indicates, that there are many uncertainties about financial relationships in the new environment and an even more cautious approach to projections than usual would seem warranted. The expectation that M_1 growth should slow in the months ahead appears quite plausible, particularly in light of the very rapid expansion that has taken place so far this year. Bank credit, on the other hand, might well expand more rapidly than the blue book indicates. New interest rate expectations should encourage banks to strengthen their investment activities, and there should be an expansion of loan demand as the economy recovers, particularly if business takes advantage of price stability during the freeze period to build up inventories.

The blue book presents two basic alternative approaches to the policy period ahead, involving rather different sets of money market conditions. Alternative A (and perhaps D) would keep a 5-3/8 to 5-3/4 per cent range for Federal funds, whereas alternative B (and perhaps C) would involve a distinct easing of that rate to a 4-1/2 to 5 per cent range. As I noted earlier, many people in the market are anticipating some downward drift in the Federal funds rate from the 5-5/8 per cent level that has prevailed recently. I believe there is a considerable risk, however, that a funds rate of 5 per cent or lower would set off a considerable speculative binge on the part of dealers and banks, pushing interest rates generally to lower levels that might not be sustainable. On the other hand, there is the risk that maintaining the funds rate at prevailing levels would cause some back-up in rates, and I assume the Committee--while willing to see some backing and filling as

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

developments unfold--would not want to see the general level of interest rates move back to the August 13 levels in the period ahead. Guidance from the Committee on the System's posture with respect to interest rates generally would be most helpful for the conduct of operations.

While the outlook appears favorable for some slowing of M_1 growth, the fact remains that growth in the current month is quite strong, and the weakness is all in the projections. An easing of money market conditions that was accompanied by visible evidence that M_1 growth was slowing would, I believe, be accepted by the market as a reasonable course of central bank action. A pronounced easing of money market conditions, on the other hand, while the published numbers show strength in M_1, might well be interpreted in the market as a premature move by the System, leading to doubts that fundamental financial conditions will in fact be conducive to putting an end to inflation.

Market psychology is of considerable importance at the present time, with the general mood very constructive. Uncertainties, however, remain both on the domestic and international sides, and market participants are looking to our actions as a clue to System intentions. I believe the Committee should pay close attention not only to what we do in the weeks ahead but also to how the markets will interpret our actions. This will call for a flexible approach to day-to-day operations within the framework of the general policy course the Committee decides on today.

By unanimous vote, the open market transactions in Government securities, agency obligations, and bankers' acceptances during the period July 27 through August 23, 1971, were approved, ratified, and confirmed.

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

Mr. Partee made the following statement:

The Administration's new economic program profoundly affects the outlook for the months ahead. The 90-day wage-price freeze, the relative increase in prices of imports compared with domestic goods, the various changes proposed in taxes and in Federal expenditures, and the potential effects of the program on public psychology--all will influence economic activity in ways that are extremely difficult at this point to foretell. The short-run impact, however, clearly runs in the direction of increased stimulation of the domestic economy and a considerable slowing, at least temporarily, in wage and price escalation.

The size and scope of this abrupt change in economic environment makes the pattern of prior events less relevant for the future than is usually the case. For the record, however, the business news in the weeks preceding the President's statement continued the spotty character of other recent months. The trend of employment was exceptionally weak in June and July, and growth in wage and salary income slowed. Retail sales dropped back last month, following large second-quarter gains, while the domestic car market continued lackluster. Industrial production also declined in July, mainly reflecting strikes and strike-related adjustments, and a further decline in August seems very likely. New housing starts and building permit volume continue strong, on the other hand, and new orders of durable goods manufacturers showed a sizable gain in July. The rise in consumer prices also slowed abruptly last month, although the more general pattern of price increases--as well as the trend of wage rates--still pointed to substantial underlying inflationary momentum.

A number of the more basic aspects of recent economic performance seem to me of importance in shaping responses to the new program. First, the strength of housing and, to a lesser extent, State and local construction programs, is still helping to carry the economy upward. There appears to be no reason to expect any weakening in these sectors in the months ahead, provided that credit remains in good supply and interest rates do not become a serious constraint. Second, the personal saving rate has been exceptionally high, reflecting consumer pessimism and uncertainty, and there would thus seem to be ample room for a substantial strengthening in consumption if attitudes should improve in response to the new policies. Third, output of business equipment and defense products has already dropped very substantially

from the 1968-69 highs, and a leveling off in such production, if not a turnaround, now seems in prospect. And fourth, inventory ratios have declined considerably over recent months, so that stronger sales would be likely to bring about a prompt revival in inventory investment--aside from steel and perhaps some other metals.

These considerations underlie the staff's revised GNP projection presented in the supplement to the green book[1/]. The projections are unusually tenuous, reflecting our difficulties in assimilating and quantifying the possible effects of the new program in the absence of any hard information on reactions by the public and Congressional intent. We will present estimates for the first half of 1972, and will probably be revising the second half of 1971 also, prior to the next meeting of the Committee. At present, it appears to us that a significant strengthening in real terms, compared to our earlier expectations, is the most likely prospect for the domestic economy. Nominal GNP in the next two quarters is projected a little lower than before, due to the slowing in price inflation, but real activity is expected to expand considerably faster. Thus, our new projection is that real GNP will rise at a 3.1 per cent annual rate in the third quarter, versus 2.7 per cent before, and then accelerate to something like a 6-1/2 per cent rate of gain in the final quarter of the year. The relatively small third-quarter improvement reflects the fact that the quarter was half over before the program was announced and the probability that any upsurge in final sales would initially come out of inventories in any event.

The major short-term hope is that consumption may respond strongly to the President's program. This is most likely in automobiles, where the 1972 price increase has been rolled back, factory prices will be reduced further by the retroactive termination of the 7 per cent excise tax, and domestic models will be favored over foreign makes by the import tax and possibly by exchange rate adjustments as well. But consumption more generally could also increase fairly strongly in real terms. The initial public reaction to the wage-price freeze was highly favorable, judging from last week's special Gallup

---

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

poll, and consumer confidence may thereby be strengthened. In addition, with the price freeze temporary, some purchases may be speeded up in the expectation that prices could move up again after the 90-day period.

Increased real consumption, after a lag, should produce a demand for restocking and enlargement in both distributor and manufacturing inventories, and lead to a pickup in industrial output. We have assumed that some of this would occur by the fourth quarter, but a more substantial recovery in inventory investment would be likely in the first half of next year. Similarly, the 10 per cent investment tax credit--scheduled to fall back to 5 per cent a year hence--should stimulate business equipment expenditures, particularly in an environment of strengthening markets and increasing production. But most of the effects on investment outlays will be delayed until next year, given equipment order lead-times and uncertainty as to the details of the incentive as it may be modified by Congress. On balance, then, it seems probable that a good deal of the stimulus from the President's program on the private sector would have its effects in 1972 rather than in 1971. On the other hand, cutbacks in Federal spending and payrolls from projected levels, to the extent that they occur, will have a dampening influence on economic activity centered in the first half of 1972.

The form and effectiveness of restraints on wages and prices beyond the 90-day freeze period is also very much in question. Presumably any such program would permit a resumption of at least moderate wage advances, and prices could adjust upward too, particularly in the initial post-freeze period. But I would assume that the restraint program, reinforced by higher productivity growth, will be successful in keeping prices from rising as rapidly after the freeze as they did before. Thus, the expansion in nominal GNP on into 1972 seems likely to continue to reflect a larger real--and smaller price--component than we had been projecting, and may not turn out notably higher in total than we had been anticipating before.

Transactions demands for money, therefore, may be no larger over the next few quarters than we had previously projected. The question is whether the rate of growth in the money supply should now be reduced relative to earlier projections. A slower growth is not necessarily justified by the prospect that there will be less inflation in the GNP to be financed, assuming

that the Committee supports the objective of faster real economic growth than previously expected. But a slower monetary expansion might well be justified for a time, to the extent that the public's demand for cash balances this year has been inflated by special precautionary considerations that will now be reversed.

This sort of analysis must be very conjectural at present, but my preliminary judgment is that a smaller rate of monetary expansion than the 8 per cent we had assumed in the chart show for the second half of 1971 would not be inconsistent with the objectives of the new economic program. At the same time, it is important to recognize that market interest rates, in the near term, should come down too. Interest rates have seemed very high this spring and summer relative to the underlying supply and demand situation in credit markets. Presumably yields have reflected a special allowance for the inflationary expectations of borrowers and lenders, which should now diminish. Put another way, the real cost of credit, as a result of the President's program, may increase appreciably if nominal rates do not respond by adjusting to lower levels. The prospects for resource utilization in the economy do not yet seem strong enough to warrant a tightening such as this in credit conditions.

In view of all the current uncertainties, I would recommend that the Committee seek to find a neutral stance in monetary policy for the time being. By neutral, I mean a policy which neither forces deposits on a public whose demand for liquidity is waning, nor holds interest rates up when market conditions would otherwise bring a decline. The difficulty is that I don't have any precise notion of what either number should be. The chances are that growth in the demand for money will slow as much or more over the next several months as is projected in the blue book, although the next week or two could well show a bulge in money stock related to the surge in financial transactions and distortions in the normal pattern of international financial transactions. But the chances also are that credit markets should clear at lower interest rates, reflecting a decline in the inflation premium.

Interest rates on market securities dropped significantly last week. There may now be a temporary backup, but I think that the basic tendency towards lower rates should be encouraged, particularly during the next 80 days when the behavior of interest rates--which, unlike most

other prices, have not been frozen--will be under close observation. Toward this end, I would recommend permitting the Federal funds rate to decline promptly in line with other short-term rates, perhaps to around the 5 per cent level. From that new level, I would then be inclined to move the rate rather forcefully in either direction if the behavior of M_1 and M_2 appears to be departing significantly from the paths specified as consistent with alternative B.1/ I would not give much weight in this strategy to the bank credit proxy, since a possible temporary spurt in bank portfolio investment--reflecting the improved outlook for security prices--would have little significance for the underlying economic situation.

The Chairman then called for a general discussion of the economic and financial situation and outlook.

Mr. Coldwell remarked that the President's new program certainly had shock value, and it was of obvious importance in other respects. He wondered, however, whether it really affected some of the fundamentals in the present situation, particularly with respect to inflation. Personally, he considered the longer-run outlook to remain heavily tinged with inflation; in his judgment the stimulus implicit in a large fiscal deficit and rapid growth in money was sufficient to perpetuate upward pressures on prices.

Mr. Coldwell noted that he shared Mr. Partee's view that the expansion in housing had provided the main support to the recovery thus far. Like others, he had been looking to consumers to begin spending some of their large accumulation of funds. Evidently,

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

however, the uncertainties facing consumers were so great that they were still holding back; and, if anything, the new program probably increased rather than reduced their sense of uncertainty. Consequently, he did not expect any great change in the pattern of consumer actions as a result of the program--except perhaps for some increase in purchases of automobiles.

Chairman Burns observed that such an increase in auto purchases could make a significant difference in the over-all economic situation.

Mr. Coldwell agreed, but added that he doubted whether a viable recovery could be supported on that basis alone. In general, he questioned whether optimism about the outlook was warranted, at least until some fundamental uncertainties--including those in the international financial area--were resolved.

Mr. Mayo commented that Mr. Partee had properly emphasized the difficulty of making any economic projections at a time like the present. He had no particular reservations about the staff's projections except perhaps with respect to the outlook for the unemployment rate. The unemployment rate tended to be sticky, and if improvement in economic activity encouraged people to enter the labor force it might well be higher than the projections suggested. In light of prevailing uncertainties he would suggest a cautious approach to monetary policy at this point. In particular, he thought the specifications associated with whatever directive

the Committee adopted should encompass a wider range than those suggested in the blue book in connection with either alternative for the directive.

Mr. Francis said he continued to feel that the performance of the economy was generally satisfactory. In his view much of the gloom about the slow response of the economy in the current recovery was not justified. The relationship between the level of real output now and at the prerecession peak was in line with that prevailing the same number of months after the peak during other recoveries in the postwar period. The difference this time was that the stabilization policies followed during the recession phase had been successful in preventing real output from declining as much as it had in earlier recessions. In light of that difference, a recovery as rapid as that experienced earlier should not have been expected.

In his judgment, Mr. Francis continued, the policies followed in 1969 and 1970 had been quite good in tempering the decline in activity and in setting the economy on the road toward recovery. However, the very rapid growth in money thus far in 1971 had built up strong inflationary expectations. The President's address had had a major impact in that area; judging from the reactions of people with whom he had talked, inflationary expectations had been modified and confidence restored, at least temporarily. With respect to the international position of the dollar--which had

been an area of considerable concern for some time--he thought the measures the President had announced could turn the situation around and, if there were a proper follow-through, could prove very helpful over the longer run. It was still his belief, however, that the longer-run state of the dollar would depend ultimately on the effectiveness of over-all stabilization policy, including monetary policy.

Mr. Brimmer remarked that he did not share Mr. Coldwell's view that the new economic program had not had a fundamental impact on the situation with respect to inflation. The fact that a new set of policy instruments had been brought to bear meant that the burden of fighting inflation would no longer fall so heavily on monetary policy. While monetary policy still had a significant role to play in the battle, it was important to recognize that a watershed had been passed.

Chairman Burns said he might add a footnote to the effect that, while the nation had started down a new path, it remained to be seen how long it would stay on that path.

Mr. Coldwell asked whether Mr. Brimmer would not agree that the ultimate outcome under the new economic program would depend to an important extent on the kind of monetary policy pursued, and Mr. Brimmer responded affirmatively.

Mr. Hayes observed that while he had no difficulty in accepting Mr. Partee's economic analysis he did not concur in

the latter's conclusions about the implications of that analysis for policy--a subject he would return to later in the meeting. He certainly welcomed the President's domestic program and agreed that it had changed the atmosphere for the better. Like others, however, he thought it remained to be seen whether there would be an effective follow-through, both in combating inflation and in providing the proper degree of stimulus to the economy. If the effect on inflationary expectations achieved by the announcement of the program was not sustained, the recent welcome decline in long-term interest rates was likely to be reversed.

Mr. Hayes added that he was quite concerned about the international outlook, which seemed to him to be full of uncertainties and difficulties. Market reactions to those uncertainties could have unfavorable consequences for the domestic economic situation.

Mr. Morris noted that at recent meetings the Committee had focused on the problem of rapid growth in the monetary aggregates. Its efforts to slow that growth by fostering higher short-term rates had met with only partial success. At the last meeting he had expressed concern that, given existing institutional rigidities, interest rates were approaching the point at which the viability of the expansion in residential construction would be threatened. Happily, the President's new program had reduced the risk of such a development.

In his judgment, Mr. Morris continued, it would be premature to shift to an overtly easier monetary policy now, on the basis of projections suggesting that growth in the monetary aggregates would slow. To make such a shift before it was clear--not only to the Committee but to the public as well--that growth in the aggregates had in fact slowed would not serve to reinforce the new economic program; rather, it would damage the sense of confidence that had been engendered by the President's address. Accordingly, he thougnt the Committee should hold its ground for the time being.

Mr. Eastburn asked for the Manager's judgment about the likely reaction if the market came to believe that the System was attempting to limit movements in interest rates to a range close to the levels prevailing before the President's address.

Mr. Holmes commented that market participants had watched interest rates decline sharply over the past week without any apparent effort by the System to moderate their movement. In his judgment few, if any, observers expected rates in general to move back up to their earlier levels.

In reply to a question by Mr. Daane, Mr. Holmes said he thought those expectations were likely to persist if the System moved in to supply reserves at any sign that rates were tending to back up. He was not prepared to say whether the consequences of such action would be good or bad.

Chairman Burns expressed the view that if interest rates--particularly those over which the System had the most control--were to move lower immediately after today's meeting, observers would conclude that the System was taking a deliberate step toward ease in order to encourage still faster growth in the monetary aggregates. The effect, in his judgment, would be to nullify the favorable impact that the announcement of the new economic program had had on confidence. He thought the System would have to exercise great care if the change in expectations which that program was designed to produce was to take hold. In that connection, he endorsed completely Mr. Morris' comment on policy. Even if the Committee had any intention of stimulating faster growth in the aggregates--which he doubted--this would not be the time to signal that intention to the market.

Mr. Axilrod suggested that the market's reaction to further interest rate declines would be quite different if it were clear at the same time that growth in monetary aggregates was slowing noticeably.

Chairman Burns agreed. He added, however, that evidence of significant slowing in the aggregates could become available only after several weeks, whereas a sharp decline over the next few days in, say, the Federal funds rate would become known to the market immediately.

Chairman Burns then suggested that the Committee turn to the discussion planned for today of the possibility that its ability to achieve its objectives would be enhanced if it placed greater emphasis on member bank reserves in the current policy directive. As he had noted at the previous meeting, a recommendation along that line made by the committee on the directive--consisting of Messrs. Maisel, Morris, and Swan--in its original March 1970 report had never been fully considered by the Open Market Committee. The directive committee had been asked to review the subject again, and their current thinking was reflected in a document entitled "Interim Report of the Committee on the Directive," which had been distributed on August 10.[1/] The Chairman invited Mr. Maisel to open the discussion.

Mr. Maisel said he might summarize the highlights of the interim report. He then made the following statement:

> First, the directive committee recommends that the directive be drawn so as to instruct the Manager to attain a particular level of reserves on a week-by-week basis as specified in advance in the blue book. However, he would also be instructed to diverge from this path in accordance with prior variances of reserves around the path sought and in accordance with maximum acceptable movements in short-term interest rates. The path would be selected from several offered in the blue book, each believed consistent with a separate policy.
>
> Second, it should be clear that this proposal does not affect the manner of or the difficulties which the Committee faces in determining policies. It is concerned solely with operating instructions. The

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

directive committee assumed that after the Federal Open Market Committee selected a policy, it would want to improve its control over how that policy (measured by changes in one or a group of intermediate monetary variables) actually develops. The purpose of our recommendation is to aid the Committee in obtaining this better control.

Third, our report lists some of the advantages to the Committee of a shift in its operating instructions:

(1) Directives would be drawn up in terms of what the Federal Reserve can control. We would have a good chance of actually meeting our targets. At the same time, it would be clearer both internally and to the public as to the degree to which movements in monetary variables result from operations under the control of the Committee or from outside forces.

(2) Our skill in estimating the relationship between money market conditions and movements in the intermediate monetary variables has proven to be less than perfect. We believe that using reserves as an operating target will improve control since it will tend to keep the System from adjusting reserves automatically as a result of unspecified and undesired shifts in credit demand.

(3) Today we see a good example of the problem of using money market conditions for operating instructions. At our last meeting, we picked a Federal funds rate which it was believed would result in the proper movements in the monetary variables for the remainder of the year. As a result of the President's new economic policy, those relationships must have shifted. What money market conditions should now be selected as a result of this shift? The staff has little knowledge of what new relationships may develop. They can give only slight advice regarding the operating instructions that are likely to lead to the policy the Committee selects. We could search for the new desired relationship by gradually moving the Federal funds rate, although we don't really know whether to start moving it up or down. In contrast, if we use reserves as an operating target, the money market conditions which develop will reflect the market's view of demand relative to our ideas of how we would like the monetary variables to develop.

(4) We believe that additional flexibility will develop since the market will not have to overreact expectationally to small changes in the Federal funds rate. At the moment, since they recognize the Federal funds rate is almost completely dominated by the policies of the Committee, the market properly reacts to any small movements in the Federal funds rate which they assume reflect policy changes.

Finally, your directive committee does not promise that changes in the directive will insure any rapid or major solution to our problems. We do, however, believe the proposed procedure is more logical and an improvement. Operations should be marginally better. As experience with the new procedure is built up, prospects that large improvements will result appear better than if current procedures are continued.

In response to the Chairman's inquiry, Mr. Swan said he had nothing to add to Mr. Maisel's summary at this point.

Mr. Morris said he might offer a little historical perspective. The directive committee had originally been appointed by Chairman Martin immediately following the experience of 1968. As the members would recall, in the second half of that year a policy oriented toward money market conditions had generated larger increases in the money supply than any member of the Committee had thought proper. The basic problem at that time was that the economic forecast the Committee was using erred in underestimating the strength of aggregate demands. The directive committee submitted its original report in March 1970. What evolved might be described as a "halfway house"; the Open Market Committee followed the procedure of adopting targets for the monetary aggregates while adhering to money market conditions as a guide for the implementation of policy.

The Committee had been operating in that manner for a year and a half, Mr. Morris continued. He believed that most members felt the results had not been completely satisfactory. In particular, a serious problem had been encountered in the second quarter of 1971. In that instance, the basic difficulty was not with the economic forecasts; the staff's GNP projections proved to be as accurate as anyone might reasonably expect. The problem resulted from a larger-than-anticipated increase in the precautionary demand for money. Following a money market guide, the System had permitted a much greater expansion in the money supply than appeared desirable in retrospect. In short, by following a money market rather than a reserve guide, the Open Market Committee had accommodated an excessive transactions demand for money in the second half of 1968 and an excessive precautionary demand for money in the second quarter of 1971.

As Mr. Maisel had indicated, Mr. Morris observed, the directive committee was agreed that moving to a reserve guideline would not solve all the problems of implementing policy. The deposit-mix problem would remain, and the Open Market Committee would have to learn through experience just how much fluctuation in short-term interest rates the market could readily adapt to. But the directive committee believed that a reserve guideline would permit better control over the monetary aggregates and would provide a much better basis for explaining to the Congress

and the public what the System was trying to do. The Open Market Committee was on record earlier in the year as trying to achieve a 6 per cent rate of growth in the money supply, but the second-quarter growth rate had turned out to be 11 per cent. That difference suggested that under present procedures the Committee's ability to achieve its objectives was limited.

Chairman Burns expressed the view that the problem of explaining System objectives was a particularly serious one. He noted in that connection that the Committee also was on record with respect to its objectives for interest rates, and the question was frequently raised as to why lower rates were not being sought.

As the Chairman had indicated, Mr. Morris continued, the Committee now set targets not only for the aggregates but also for interest rates; and the Manager often found it impossible to achieve both objectives. Under the proposed new procedure, the Committee would call for an increase in reserves of X per cent, the rate appropriate to support increases of Y per cent in M_1 and Z per cent in time deposits. Actual growth rates in the latter variables might often differ substantially from Y and Z, but it could be made clear that those differences reflected a divergence between the expected and actual preferences of the public with respect to the mix of deposits.

It was for such reasons, Mr. Morris concluded, that the directive committee had reached essentially the same conclusions in its

latest report as it had in its original report a year and a half ago.

In response to the Chairman's inquiry, Mr. Morris said he thought that experience since March 1970 had strengthened the case for the course recommended by the directive committee.

Mr. Maisel agreed that the case with respect to operating procedures had been strengthened; personally, he felt somewhat less hesitant now than eighteen months ago in asserting that the recommended course would help the Committee achieve its policy objectives. Recent experience also had suggested that the Committee should employ a more complex method of arriving at those policy objectives, but that would be true whatever operating procedures were followed.

In response to the Chairman's request for comment, Mr. Axilrod said he would make just two points. Of the four staff people who had worked on background material for the interim report, three--including himself--believed that moving to a reserve target would be a step forward in that it would improve marginally the Committee's ability to achieve its objectives for the monetary aggregates. The staff members also thought that focusing public attention on reserves, which the System could control closely--rather than on the money supply and time deposits, over which it has less control--would have the advantage of avoiding some of the effects on expectations that could develop under present

procedures when, say, there was a large unanticipated shift in the demands for either demand or time deposits. Like the directive committee, the staff felt that the change would not solve all of the Committee's problems with respect to the directive. Rather, it would be a small move in the right direction.

In reply to a question by the Chairman, Mr. Axilrod said he did not think the staff expected less from the proposal than did the directive committee.

Chairman Burns then asked the Manager to comment.

Mr. Holmes expressed the view that the basic problem derived not from the language of the directive but from the fact that the Committee's objectives for interest rates and for the aggregates could prove to be mutually inconsistent. Such conflicts had to be resolved somehow, and one possibility was to decide to focus on the aggregates and let interest rates go where they would. However, there were times--such as the second quarter of this year--when the Committee apparently was not prepared to follow that course.

Another possibility, Mr. Holmes continued, would be for the Committee to decide on a change of emphasis under which more weight would be given to the aggregates and less to interest rates. However, a great deal would depend on the operating procedures employed. In that connection, he was not reassured about the desirability of a reserve target when he considered, for

example, what the consequences would have been in the period after the Committee meeting of June 29, 1971, if the Desk had used for target purposes the path for reserves shown in the blue book prepared for that meeting. With such a target the Desk would have been required to supply more reserves than it in fact did, and money market conditions consequently would have eased. That development would have been particularly unfortunate from the point of view of timing; during the period following the June 29 meeting the discount rate had been raised and Chairman Burns had testified about the need for a strong anti-inflationary program at the Joint Economic Committee hearings. He thought such a combination of events would have produced a marked credibility gap. While the Committee might desire to have more emphasis placed on reserves, he thought great caution was needed in view of the risk of producing unwanted movements in interest rates.

Chairman Burns noted that the directive committee proposed that operations under a reserve target would be constrained by the specification of a maximum acceptable range of movement in short-term interest rates. He asked whether such a constraint--perhaps limiting changes in the Federal funds rate to a range of 1-1/2 or 2 percentage points--would avoid the risk Mr. Holmes had mentioned.

Mr. Holmes responded that he would still be concerned about the problems of specifying a reserve target. It would be

unfortunate if the market were forced to adapt to fluctuations in money market conditions that arose only because of errors in the staff's projections of reserves.

The Chairman commented that the problem of projection errors existed under present procedures. He asked whether the Manager would agree that the problem would be reduced under the proposed procedure, since it would be necessary to make assumptions only about the relation between reserves and the monetary aggregates and not to introduce additional assumptions involving the relation between the Federal funds rate and reserves.

In reply to this and subsequent questions, Mr. Holmes said he did not think there would be less of a projection problem under a reserve guide. As the Committee knew, reserves were influenced by many factors outside the System's control. They fluctuated widely; during 1970, for example, their week-to-week variations averaged $550 million, and in some weeks the change was $2 billion or more. Moreover, the changes were quite difficult to predict. That was demonstrated by the fact that the error in the projections made at the New York Bank at the beginning of each statement week averaged $250 million during 1970. It probably also could be demonstrated by comparing the projections given in past blue books for the various aggregates covered with the actual outcome for corresponding periods; he thought such an analysis would indicate that the errors in the projections

of reserves were proportionately larger than those in the other aggregates.

Under present procedures, Mr. Holmes observed, the Desk began each inter-meeting period with a view to maintaining the money market conditions believed to be consistent with whatever combination of objectives the Committee had specified--perhaps involving both aggregates and interest rates. As the period unfolded it supplied reserves more or less liberally, depending on the evidence available concerning the actual performance of variables with which the Committee was concerned. In that process, the Desk used the Federal funds rate as a guide to the availability of reserves. The situation frequently arose in which reserve estimates might indicate, for example, that there was an ample supply of funds in the market at the same time that upward pressure on the Federal funds rate suggested a deficiency. Experience had demonstrated that at least 70 per cent of the time the behavior of the funds rate was the more reliable guide to the actual reserve situation. In his judgment, the Desk's ability to meet the Committee's objectives would not be improved if it ignored that evidence.

Mr. Mitchell remarked that he would not favor adopting the directive committee's recommendations even though his ideological position on the subject of monetary aggregates was similar to that of the committee members. The question under debate was which variable out of the complex affected by open market operations

was to be preferred as a guide to operations. The Desk favored money market conditions--particularly the Federal funds rate--and the directive committee recommended reserves. In theory, any of the variables in the complex could be used, because they were all interrelated. However, he thought the present would be a singularly inappropriate time to shift to reserves, partly because the public's preferences between money and near-money were especially unstable now.

Mr. Mitchell went on to say that particular rates of change in reserves were not an end in themselves; they were of interest only in that they affected the changes in other variables, such as M_1, M_2, bank credit, and interest rates. In his judgment it would be undesirable for the Open Market Committee to concentrate on any one such variable. Looking back over 1971 to date, he was not sure now that either M_1 or M_2 had grown at an inappropriate rate. Looking ahead, he agreed with Mr. Partee that some moderation both in the growth rates of the monetary aggregates and in the levels of interest rates would be desirable. In any case, the Committee's real objectives would be formulated in terms of such variables and not in terms of reserves. He did not agree that a shift to a reserve target would make it easier to explain the Committee's actions; in his judgment it would amount simply to the substitution of one mystique for another.

Mr. Maisel said he agreed with Mr. Mitchell that the Committee's real concern was with the intermediate variables such as M_1 and M_2. As the interim report indicated, the precision with which an objective for an intermediate variable could be attained when using a week-to-week reserve target would depend on the staff's ability to anticipate the multiplier relationships between reserves and deposits, and experience demonstrated that misses were inevitable. Assuming the Open Market Committee as a whole wanted to stress short-run control of intermediate variables, the directive committee had planned to suggest two procedures that would improve its ability to do so. The first was to authorize System operating personnel to modify the reserve targets routinely to allow for unexpected shifts in Government deposits; in the past, such shifts had been an important source of difficulty in making reserve projections. The second was to ask the staff to prepare revised estimates of the relationships between reserves and the intermediate variables for Committee consideration about halfway through each intermeeting period, and to plan on holding a brief telephone conference meeting of the Committee at that time to decide whether the reserve targets should be modified.

Mr. Maisel then remarked that he wanted to emphasize the point that small changes in the Federal funds rate now had important effects on market expectations only because participants were aware

that the Desk operated through that rate in attempting to achieve the Committee's more fundamental objectives. A similar situation had prevailed in earlier years with respect to the three-month Treasury bill rate. In the first half of the 1960's, for example, when the Committee had been focusing primarily on the bill rate, the members had tended to think that a change of more than about 5 basis points between meetings could have undesired effects on expectations. Only three years ago--in August 1968--the System had considered it necessary to lower the discount rate because the market expected a cut, and it was feared that the bill rate would rebound if it did not materialize. That earlier pattern contrasted sharply with the situation during the past year or two, when the Committee had deemphasized the bill rate; now that rate could move by 30 or 40 basis points between meetings with no significant impact on expectations and no risk that the System's objectives would be misunderstood. Similarly, if the Committee were to deemphasize the Federal funds rate for operating target purposes by shifting to reserves, the market would no longer look to the funds rate for signals of System intentions and it could fluctuate over a much wider range than at present without undesirable consequences.

Mr. Daane commented that he agreed with the Manager's observations and also with much of what Mr. Mitchell had said. The Committee was dealing with an interrelated complex of variables,

and in his judgment all attempts to improve communication with the Manager by narrowing the focus to a few variables were bound to fail. Such efforts could succeed only if the relationships among the variables involved were sufficiently stable to permit a high degree of precision in projections, and his thirty years of experience with monetary policy suggested to him that that was not the case. One reason why things did not work out so neatly was that changes in market expectations were an integral part of the economic process, sometimes accentuating and sometimes offsetting the effects of other forces. The Committee would be deluding itself if it ignored that fact and assumed that it could translate its wishes for the whole complex of variables into some relation involving only a few.

Mr. Daane observed that over the years he had opposed the idea that the Committee could view the specific growth rates in one or more monetary aggregates as the main objective and the true measure of monetary policy. He found it significant that Mr. Mitchell, who had long urged the Committee to move in that direction, was not sure in retrospect whether or not the behavior of the monetary aggregates earlier this year was inappropriate. When the Committee formulated its policy alternatives in terms of tighter, easier, or unchanged money market conditions, it was merely using a shorthand way of talking about the cost and availability of credit. He thought that by over-particularizing its targets the Committee had weakened its ability to achieve its objectives.

The Chairman noted that Mr. Partee would be leaving soon to represent him at a meeting of the Cost of Living Council. He suggested that Mr. Partee give the Committee his comments before departing.

Mr. Partee remarked that the question under discussion was a difficult one. Whether the Committee formulated its primary instruction in terms of aggregates or money market conditions, it presumably would add a proviso clause relating to the other. Thus, it might seek some growth rates in the monetary aggregates or in reserves--probably nonborrowed reserves in the first instance--with a constraint in terms of acceptable ranges for movements in interest rates. Alternatively, it could seek some specified money market conditions, with a constraint relating to acceptable ranges for growth rates in the aggregates or in reserves. The choice was important because the projected relationships between interest rates and changes in the aggregates would be found to be in error to a greater or lesser extent. The question was whether the Committee would prefer to have the "misses" show up initially in the form of departures from expectations of money market conditions or of growth rates in the aggregates. Recognizing that either formulation would include constraints, he personally thought it would be better to give first priority to the desired rate of growth in the aggregates and to let the initial misses be reflected in money market conditions.

Specifically, he would favor setting weekly targets in terms of nonborrowed reserves. It would be understood that routine adjustments would be made in the target path for unanticipated changes in both Government deposits and the mix of deposits between city banks and country banks, and also for errors found in earlier estimates of required reserves.

Chairman Burns asked whether from the Manager's viewpoint Mr. Partee's statement of the issue appeared to be correct.

Mr. Holmes replied in the affirmative but noted that there were some questions of detailed operating procedure which would have to be worked out. The staffs at both the New York Bank and the Board had done some preliminary work in that area.

Mr. Brimmer asked whether Mr. Partee would expect the difficulty of recovering from "misses" to be about the same under the two alternative approaches he had described.

Mr. Partee replied that from the technical point of view the difficulty should not be greater in one case or the other, so long as the provisos were specified in a totally symmetrical fashion. In retrospect, it seemed to him that earlier this year the System had not permitted the Federal funds rate to move far enough when it had become evident that the aggregates were diverging from the desired paths. Because of the heavy emphasis that had been

placed on the interest rate constraint the performance with respect to the aggregates was poorer than he now thought had been necessary or desirable.

Mr. Daane asked whether Mr. Partee would in fact not have been disturbed by the consequences for interest rates of more aggressive actions to slow growth in the aggregates.

Mr. Partee noted that he was proposing some constraint with respect to interest rates. Just how strong that constraint should be was, of course, a matter for the Committee to decide, and judgments no doubt would differ.[1/]

Mr. Hayes remarked that he sympathized with much that Mr. Daane had said but would state the argument in somewhat different terms. At the outset, he would note that the Committee's present procedure was, essentially, to instruct the Manager to aim for conditions of reserve availability--not just some Federal funds rate--that were believed to be consistent with the achievement of desired growth rates in various money and credit aggregates, modified as the Committee might specify from time to time to take account of credit market conditions or other factors. He would not claim perfection for the Committee's present approach and he would welcome further explorations carried out by the directive committee.

1/ Mr. Partee left the meeting at this point.

However, Mr. Hayes said, he had serious reservations about the proposed change. First, simply as a matter of timing, he thought the present circumstances--involving a new thrust in national economic policy across a broad front and calling in his view for a most cautious implementation of monetary policy--would be most inopportune for revamping the System's approach to open market operations. Secondly, while the interim report stated some general objectives in its recommended approach, he believed it was not nearly specific enough for the Committee to be able to reach an informed judgment. He thought it would be a mistake for the Committee to endorse a reserve target approach in principle before knowing a good deal more about the general lines of implementation. There was, for example, the question of whether the objective would be total reserves or non-borrowed reserves. Those and other questions were not simply technical matters to be worked out by the staff; they could be of critical importance in deciding whether the proposal was feasible and likely to yield superior results.

Third, Mr. Hayes continued, to the extent that a specific approach was indicated in the interim report, as he understood it, there was a real question whether it would hold any prospect for achieving closer control of the money and credit aggregates. Instead, its main effect might be to subject the financial markets to sharp fluctuations in the cost and availability of reserves.

As pointed out in the report, Mr. Hayes observed, much progress had been made in the past 18 months in developing greater Committee attention to growth rates of intermediate money and credit variables. On the whole, he believed that shift of emphasis had been desirable, although at times the degree of stress on achieving particular growth rates, and especially the narrow stress on M_1, had been overdone. The Account Manager had continued to focus on money market conditions in his day-to-day operations, but that had been primarily a means of bringing about desired growth rates rather than an end in itself. Under that procedure, there had been substantial movements in money market conditions and short-term rate levels in relatively short time periods. But those had been sustained and purposeful movements in market conditions, rather than the sharp swings that seemed to be implied in the proposed approach.

Mr. Hayes thought it might well be that at times the Committee should have fostered somewhat greater movement in money market conditions in order to achieve a more rapid response in the behavior of intermediate aggregate targets. But that would be rather different from an approach that sought to achieve predetermined reserve levels and would let money market conditions fluctuate pretty much as a residual element, bound only by the limits that the Committee might indicate. The sharp fluctuations in money market

conditions likely to ensue under the proposed approach would, he believed, cause the financial mechanism to work less effectively. While the banking system and financial markets could cope with sharp weekly variations in such quantities as seasonally adjusted total or nonborrowed reserves, and indeed might be unaware of such movements, sharp variations in market conditions would be clearly and, he thought, disturbingly apparent to all participants in the financial markets. Moreover, to believe that an operational focus on reserve aggregates would help achieve closer control of monetary aggregates assumed much greater predictability in the relationship between reserve levels and money and credit aggregate levels than he believed existed. Thus, there was a real question whether, after adopting a course that entailed much sharper fluctuations in money market conditions in order to smooth out certain reserve growth measures, the Committee would in the end have achieved any better handle on the money supply or bank credit.

Mr. Hayes remarked that he was not impressed by the argument that concentration on targets for reserves, the variable the System could control most closely, would help make clear to the public what the Committee could be expected to accomplish and what developments it should be held responsible for. The Committee had increased the attention it paid to the

monetary and credit aggregates because it had become persuaded by the arguments of economists that the rates of growth in money and bank credit were of great significance to the economy. The changes in those variables undoubtedly had more economic significance than changes in reserves, and he saw no reason to expect widespread acceptance of the view that it was proper for the Committee to attempt to control reserves instead of, say, the money supply. Although the Committee used money market conditions as an operating guide, the country did not tend to judge the adequacy of monetary policy in terms of the recorded changes in such conditions; individual observers continued to assess policy in terms of the measures they considered important.

To sum up, Mr. Hayes said, he believed the best course at this time would be to defer action on the interim report and to instruct the staff to explore specific procedures that would help focus Committee attention on various reserve measures as a possible aid in policy formulation. He thought the Committee was a long way from the point at which it would want to shift to reserves for actual operating purposes.

Mr. Robertson said it was a good thing that the present discussion was being held today because it should prove helpful to the Manager in interpreting the Committee's deliberations on

policy later in the meeting. On the other hand, this seemed to him to be a bad time for the Committee to change procedures.

Mr. Robertson noted that the possible use of total or nonborrowed reserves for target purposes was not a new idea. Indeed, the Committee had engaged in debates about the merits of that type of target as long ago as the 1959-61 period. In those discussions no one had argued that reserves were necessarily the ideal guide to operations. The objective then--and later--was to move away from the kind of guide the Committee had employed for many years, relating to the "tone, color, and feel" of the market. Over the years, he and other members had argued that the Committee should reduce the emphasis it placed on small changes in money market rates and permit those rates to fluctuate over wider ranges. Thus, he was sympathetic to the objectives of the directive committee. However, he would not want to make the kind of shift they recommended unless it was preceded by a public announcement, since the appearance of larger fluctuations in money market rates would otherwise be likely to have undesired effects on psychology.

Also, Mr. Robertson continued, he thought the Committee should make a careful analysis of the implications of a reserve target--or whatever new target was preferred--before it instituted a change. It would be important to keep in mind that the rate of

growth in reserves was not the only matter of concern, and that it was necessary to continue to give close attention to changes in other key aggregates and in interest rates in pursuing the ultimate objective of a monetary policy that provided as much economic stability as possible.

Mr. Daane observed that for many years the Committee had made heavy use of free reserves for operating target purposes.

Mr. Robertson agreed, adding that the Committee had shifted to the use of free reserves following the period in which it relied mainly on the "tone, color, and feel" of the market. Neither had worked well as a guide, and he doubted that there was any single measure which would, if taken alone. Thus, the money supply had grown too rapidly in recent months mainly because the Committee had been too rigid in its approach to movements in the Federal funds rate, which the market had been led to believe was the true indicator of the stance of monetary policy.

Mr. Coldwell remarked that he could support many of the comments that had been made by Messrs. Daane, Hayes, and Robertson. It seemed to him that the problem under discussion had three aspects--theoretical, statistical, and practical. In terms of theory, he could accept the proposals of the directive committee. In statistical terms, he wondered if moving down the path

recommended would not involve simply the substitution of reserves for the funds rate as a measure the market would watch closely and react to. In practical terms, he questioned whether the Committee really would be prepared to allow interest rates to move in a wide range. That was a highly significant question for today; was the Committee prepared at this point to let interest rates move up? He seriously doubted that there was much leeway for such a movement.

Mr. Swan said he agreed with Mr. Robertson's remarks. He also concurred in Mr. Daane's observation that the Committee's concern was with a whole complex of variables, rather than with a few measures. The objective of the proposal to use reserves as a guide to operations was not to narrow the Committee's focus to that one variable, but to improve the Committee's ability to bring about desired changes in the whole complex of variables deemed significant. In effect, it was the position of the directive committee that the objectives Mr. Daane had described would be served better if reserves, rather than the Federal funds rate, were used as an operating guide.

Mr. Daane said he certainly had not meant to defend the use of the Federal funds rate as the primary guide to operations.

Mr. Maisel referred to Mr. Coldwell's question as to whether the Committee was prepared to allow interest rates to

move in a wide range, and noted that the specific rate under discussion was that on Federal funds. Until about five years ago, he said, very few people in the country--apart from Government security dealers and Federal Reserve personnel--had attached any particular policy significance to the funds rate; far more attention had been paid to the Treasury bill rate. As he had noted earlier, the funds rate had taken on its current importance only because in recent years the System had been using it as an operating guide. He thought it would be desirable to allow the funds rate to fluctuate over a wider range, just as had been done in connection with the bill rate.

Mr. Francis said he believed it would improve the Committee's ability to achieve a policy conducive to stable economic growth if money market conditions were deemphasized and monetary aggregates given more weight. Therefore, he favored the recommendations of the committee on the directive to utilize member bank reserves as an operating target for periods between Committee meetings. He urged the Committee to consider setting the target for the reserve aggregate on a three-month moving average rate-of-change basis, rather than on an end-of-quarter to end-of-quarter basis.

If there was favorable action by the Committee on the proposal by the directive committee, Mr. Francis continued, in

the course of time he would like to see the staff evaluate three additional actions that might further improve operating procedures: eliminating the provision for lagged reserve requirements, and thus the provision for carrying forward surplus reserves and deficiencies; moving towards more uniform reserve requirements on deposits by eliminating the over- and under-five million dollar distinction, and narrowing if not eliminating the discrepancy between requirement ratios for reserve city banks and country banks; and adopting a broader reserve aggregate target, such as the monetary base controlled through its source components.

Mr. Sherrill asked whether the linkage between reserve injections and M_1 was better understood than that between interest rates and M_1.

Mr. Axilrod noted that the procedure followed by the staff in its regular projection work was to attempt to develop a mutually consistent set of money supply, interest rate, and reserve relationships. The question of whether an M_1 target could be achieved better by focusing on reserves rather than on interest rates was basically one of determining where errors in projected relationships were most likely to occur. The staff did believe that the Committee would obtain somewhat better control of the monetary aggregates with a reserve guide than it now had with a Federal funds guide, although it was not clear that the difference would be great. The course of interest rates would become more uncertain since rates would be

determined to a greater extent than at present by the workings of market forces. In the staff's view, however, the increased role of market forces in rate determination was an advantage of the proposed procedure.

Chairman Burns remarked that Mr. Sherrill's question could be best answered in terms of the results of a statistical analysis. He asked whether the staff had carried out such an analysis.

Mr. Axilrod replied in the negative, although the staff was in the process of comparing the accuracy of predicted relationships between money market conditions and M_1 in the blue book with that of predicted relationships between reserves and M_1 from other sources.

Mr. Maisel asked whether the St. Louis Reserve Bank had made statistical calculations of the kind under discussion.

Mr. Jordan replied that the correlations run at the St. Louis Bank involved simulations, and they followed the general approach Mr. Axilrod had described. Accordingly, they did not throw direct light on the question at hand.

Mr. Kimbrel commented that he was rather inclined to favor the recommendation of the directive committee. Perhaps he felt that way partly because Malcolm Bryan, a predecessor of his as President of the Atlanta Bank and one of his former teachers,

had argued strongly as long ago as 1960 that the Committee's directive should be couched in terms of total reserves. He recognized that the proposed procedure would lead to a wider range of fluctuation in interest rates, and he thought that the Committee should be prepared to accept a range considerably wider than ordinarily occurred at present. Having said that, he would add that in his judgment this was a poor time to make the change.

Mr. Heflin observed that he had asked his associates at the Richmond Bank a question similar to that Mr. Sherrill had raised today--namely, whether the linkage appeared to be stronger between the reserve base and the aggregates than between interest rates and the aggregates. He had been told that in the short run the linkage was probably weaker; there appeared to be large short-run shifts in the relationship between changes in reserves and in the monetary aggregates. In the long run, however, the linkage seemed to be reasonably strong.

On balance, Mr. Heflin continued, he felt there was little reason to prefer one approach or the other on the grounds of closeness of linkage. Also, he agreed with those who believed that, other things equal, this was not a good time to make a change in operating procedures. Under present circumstances the swings in interest rates that could result might seriously mislead the public about the Committee's intentions. He could see that

objection aside if he thought the change would make it easier for the Committee to explain its position to the Congress and the public. He was quite doubtful, however, that that would be the case.

In sum, Mr. Heflin said, he would not favor adopting the proposed approach at this time. He understood that a good deal of research was in progress at the Board and at the New York Bank. The evidence developed in that work over coming months should permit the Committee to arrive at a more informed judgment at a later time.

Mr. Morris said he would like to clarify one point with respect to timing. The directive committee had not meant to suggest that the new procedures be adopted today; it agreed with those who suggested that considerable work remained to be done in developing detailed operating procedures and that any change along the lines recommended should be preceded by a public announcement. Perhaps some members had been misled with respect to the directive committee's intentions by the fact that the staff had incorporated additional information in the current blue book about expected paths for reserves.

Mr. Maisel concurred in Mr. Morris' observation. He added that the staff was prepared to present proposals for detailed operating procedures when the Committee desired.

Chairman Burns proposed that the Committee proceed on the assumption that no change was to be made in the format of the directive today, and that the purpose of the discussion was simply to determine whether there was substantial sentiment in favor of moving in the proposed direction.

In reply to a question by Mr. Mitchell, Mr. Maisel said the directive committee had briefly considered the implications of its proposals for the current procedure of lagged reserve accounting. That was one of the technical issues which would have to be resolved. Among the possible changes were the elimination of lagged reserve accounting and an increase in the allowable carryover.

Mr. MacLaury remarked that his views were similar to those the Manager had expressed earlier. In his judgment the problems the Committee had faced this year in limiting the rate of growth in the monetary aggregates resulted from its unwillingness to tolerate wide swings in the Federal funds rate. If the Committee was now prepared to accept wider swings for the sake of better control of the aggregates it could put that intention into effect under the present type of directive, simply by calling for stronger action by the Desk under the proviso clause. He was not persuaded that the use of a reserve target would lead to any better results than could be obtained by that means.

Mr. Mayo said he would be willing to see the Committee undertake an experiment with the proposed new type of operating target, although he agreed that the present was not the best time to do so. He was not persuaded that use of a reserve guide would lead to an improvement in the Desk's operations; he had a simpler reason for favoring the experiment. In the parlance of the card player, the Committee had made a different suit superior each time it changed its main guide to operations. Such shifts had the advantage of keeping market participants from concentrating unduly on some one measure in assessing the likely course of policy. At the moment he thought there was too much concentration on the funds rate and M_1, and accordingly that it would be desirable to name another superior suit soon.

Mr. Brimmer observed that he did not have much sympathy for the approach recommended by the directive committee and would not want to move in the direction they proposed. As Mr. Morris had suggested, the Committee had moved to a "halfway house" in debate on the directive committee's original proposal, and in his judgment it had been incorrect. One way to resolve the present problem would be to move back to the earlier procedures.

Mr. Brimmer added that it might be desirable to ask the Manager to keep a running record over the next month or so of the operations he would have conducted had the Committee actually been operating on the proposed new basis.

Chairman Burns asked whether Mr. Brimmer's suggestion for continuing study of the proposal might not imply that he had somewhat more sympathy for it than his preceding comments had indicated.

Mr. Brimmer replied that he would not want to be recorded as agreeing in principle with the proposal. At the same time, he was aware that the directive committee and the staff had done a great deal of valuable work in connection with its development, and he thought some continuing simulation studies, especially by the Desk, would be worthwhile.

Mr. Axilrod commented that the staff had considered the possibility of conducting simulation studies, mainly for the purpose of investigating the question Mr. Sherrill had raised earlier. The problem with such an effort was that after the first week of, say, following a reserve target the simulated world would become quite different from the real world. As a result, it was necessary to develop a weekly model in an effort to determine what would otherwise be happening, and thereby to be able to compare the results in the simulated and real worlds. The staff was now in the early stages of the development of such a model.

Mr. Brimmer remarked that the results of such an analysis would be useful. If the Committee was going to consider the proposal further it would need all the light that could be shed on the relative costs and benefits--both in the process of making the decision and of explaining it to the public and the

Congress. As he had implied, his present judgment was that the costs would outweigh the benefits.

Mr. Holmes observed that for some time the staff at the Desk had been attempting to simulate both the derivation of a reserve target and operations under it, although he would not describe that effort as very scientific.

Mr. Robertson said it would be helpful for the Committee to have the benefit of whatever conclusions the Bank reached in that effort.

Mr. Hayes observed that the views he had expressed earlier were consistent with Mr. Brimmer's. Like the latter, he would not favor the proposal on the basis of current evidence, but nevertheless he would want to encourage further study.

Mr. Daane said he hoped that in the course of its simulation studies the staff would consider what the consequences for policy would have been if the Committee had not moved to the "halfway house" in early 1970, but instead had retained its previous procedures. In its interim report the directive committee stated that under current procedures "the Committee has been far more explicit and also more flexible in its directives. The FOMC has achieved a better view of the direction in which it wanted policy to move and of the operating instructions needed to accomplish its desires." He had not seen any evidence to support that conclusion and he thought it would be helpful to determine whether it was supportable.

Mr. Axilrod commented that while the staff would be happy to explore that question it was not wholly clear to him how the investigation Mr. Daane had in mind might be conducted.

Chairman Burns observed that Mr. Daane might want to work closely with the staff in developing the analysis he had proposed.

The Chairman then said he would attempt to summarize briefly the consensus that seemed to have emerged from the discussion of the directive committee's interim report. It appeared that, while the Open Market Committee did not want to adopt the proposed new procedures at this time, the members were by no means prepared to dismiss the proposal. Rather, they wanted the directive committee to go forward with its work; they would like to know the results of the simulations done at the New York Bank and of any undertaken by the Board's staff; and they would like to be informed of conclusions that might be reached in investigations along the line Mr. Daane had suggested. He asked whether there was any disagreement with that statement of the consensus.

No disagreement was expressed.

The Chairman then proposed that the Committee turn to the subject of current monetary policy and the directive to be issued to the Desk. In view of the lateness of the hour he suggested that the members make their comments brief. Those who had prepared statements might summarize them and submit the full statement for inclusion in the record.

Mr. Hayes summarized the following statement:

Although the economic setting for the determination of policy has changed radically as a result of the President's new program, it is impossible at this time to quantify just what the program implies. It is particularly hard to measure the extent to which we should alter our objectives with respect to the money and credit aggregates. Presumably, considerably lower growth rates for the aggregates in the coming months would be appropriate, for two reasons. First, the price freeze implies that a smaller growth in nominal GNP should yield the same growth in real GNP that had been expected prior to the freeze. Second, the generally favorable public reaction to the President's initiatives could trigger a rise in income velocity which would also reduce the need to supply new money balances.

All of this points to the need to keep a firm rein on the banking system in the next four weeks, especially since the more buoyant atmosphere in the bond market could induce the banks to add substantially to their investments at a time when loan demand remains slack. But apart from these technical considerations, there is an over-riding reason for keeping firm control over the availability of bank reserves, and that is that the System should not create the impression of having abandoned its anti-inflationary stance simply because a 90-day freeze has been proclaimed. Longer-term wage and price restraints are yet to be developed, and with a tendency for fiscal stimulus to increase, monetary policy will continue to be needed as an ally in the Administration's efforts to check inflation.

It is not easy to translate this general policy stance into sensible operating instructions, given the continuing uncertainties both at home and abroad. Market interest rates of all maturities have already dropped substantially, no doubt in large part because of the smaller factor of inflationary expectations. There is also some thought in the market that monetary policy may in due course be relaxed somewhat in the light of the severe anti-inflationary measures being taken by the Administration. While it would be foolish for the System to try to restrain this natural downward pressure on interest rates, I would reiterate that we should carefully avoid any relaxing of reserve availability to the banking system until there is visible evidence that the monetary aggregates are coming under control.

I think the best assurance of an impression of steady moderating pressure on the aggregates would lie in keeping the Federal funds rate in a range somewhere near where it has been over the past month. A funds rate ranging between 5-1/4 and 5-3/4 per cent appears quite appropriate to me, but I believe the Manager should be given ample leeway to use his discretion as events unfold. Incidentally, I would like to see weight given to bank credit as well as money, although I recognize the special importance of slowing the growth of M_1 because it is the subject of such close scrutiny by the market and political observers. As far as the staff's draft of the directive is concerned, I find it hard to understand why the phrase "moderation of short-term capital outflows" has been deleted from the first paragraph. I think the Committee will still be trying to moderate such outflows and should continue to acknowledge that objective in the directive. With respect to the second paragraph, the blue book specifications for alternative A are not far from what I have in mind. Since the main thrust of our policy at this stage should be to moderate growth of the aggregates from their current and past levels, I would prefer to couch the directive in aggregative terms. Retaining essentially the language that we used at the last meeting would appear to do the trick. That is, the second paragraph of the directive would read:

> To implement this policy, the Committee continues to seek to achieve more moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with those objectives.

It would seem to me clearly undesirable to switch at this meeting to a new reserve target. Neither the Committee nor the staff has had an opportunity to explore the detailed procedures that might be involved. I believe it would be far safer to retain the existing approach if we want to be sure to convey an impression of steadily maintaining pressure on the banking system.

The Committee briefly considered the arguments for and against restoring the reference to "moderation of short-term capital outflows" in the first paragraph of the directive, as Mr. Hayes had suggested. After discussion, a majority of the members indicated that they would prefer to omit the reference.

With respect to Mr. Hayes' proposed language for the second paragraph, Chairman Burns asked whether the purpose might not be served equally well by the language of alternative B of the staff's drafts, if the statement that the Committee sought "to promote moderate growth" in monetary and credit aggregates was revised to indicate that the Committee sought "to achieve more moderate growth." It would be understood that such language would be associated with the specifications given under alternative A in the blue book.

Mr. Hayes indicated that that would be acceptable to him.

Mr. Francis submitted the following statement for the record:

> In view of the recent actions taken and proposed by the Administration, I would prefer to see the Committee adopt a moderate, steady rate of growth of money in the near future. It appears to me very important that monetary actions to accompany the Administration's program avoid erratic movements in either an excessively restrictive or an excessively stimulative direction.
>
> For the fourth quarter of this year the alternatives for monetary growth specified in the blue book, that is, growth of M_1 in the range of 3 or 4 per cent, are acceptable to me. For the balance of the present quarter, mainly the month of September, I prefer the lower growth rate associated with alternative A. Although I strongly favor substantially reduced rates of growth of the aggregates compared to those experienced thus far in 1971, I would be concerned if aggregate growth ceased or became negative. On the other hand, a continuation of growth

> of the aggregates at rates experienced in 1971 to the present would, I believe, result in a reescalation of wages and prices in spite of the Administration's wage and price control program.

Mr. Kimbrel indicated that the proposal for a neutral policy stance was attractive to him. In general, he would favor the specifications associated with alternative A although he would leave open the possibility that it might prove desirable to modify them as events unfolded. Accordingly, he thought the Desk should be given a considerable amount of latitude. He had no strong preference with regard to directive language and could accept that of alternative B.

Messrs. Eastburn and MacDonald indicated that they preferred the modified version of alternative B and the specifications associated with alternative A.

Mr. Sherrill said he also favored the modified version of alternative B. The specifications associated with A appeared satisfactory, except that he would prefer to reduce the lower limit of the range for the Federal funds rate from 5-3/8 to 5 per cent. The resulting 5 to 5-3/4 per cent range would provide a broader basis for implementing the neutral policy stance he favored, by making more allowance for the possibility of a shortfall in the aggregates.

In reply to a question by the Chairman, Messrs. Kimbrel, Eastburn, and MacDonald indicated that they could accept the lower limit of 5 per cent for the Federal funds rate which Mr. Sherrill

had proposed. Mr. Hayes said he would prefer a range of 5-1/4 to 5-3/4 per cent, but he could accept a 5 per cent lower limit if that was the preference of the majority.

Mr. Brimmer said he preferred alternative A for the directive. He could accept a lower limit of 5 per cent for the Federal funds rate to give the Manager added leeway to follow the market down, but he would not want the funds rate to go below 5 per cent. He assumed that that approach would be consistent with a neutral policy stance.

Mr. Maisel said that while he also favored a neutral policy stance, he did not think the growth rates in M_1 associated with alternative A --which worked out to an average of only 3-1/2 per cent for the last four months of the year--would represent such a stance. Some question might even be raised about the 4-3/4 per cent average growth rate projected under alternative B, but that at least came closer to neutrality. Accordingly, he could accept alternative B, although he would modify the language to indicate that the Committee sought to "achieve" rather than to "promote" moderate growth in monetary and credit aggregates over the months ahead. Moreover, since he did not think enough was known about the likely relation in the period ahead between the aggregates and the Federal funds rate to use the latter as a guide, he would widen the specified range to 4-1/2 to 5-1/2 per cent. He thought

member bank borrowings averaging around $550 million would be consistent with the alternative B paths for the monetary aggregates.

Mr. Brimmer indicated that he could accept the directive language proposed by Mr. Maisel.

Mr. Daane said he was not in favor of a neutralist monetary policy. Rather, he would want to reinforce the anti-inflationary elements of the President's program to the extent it was possible to do so without putting upward pressure on interest rates; he would rely on the fiscal measures included in the program to provide the needed economic stimulus. As for the directive, he favored the spirit of the modified alternative B language, with the specifications of alternative A, even though he did not like a directive couched in terms of the monetary aggregates. The Committee would be meeting again before the time at which the blue book indicated the growth paths of alternatives A and B would diverge, In the interim, he would maintain a firm hand on the throttle.

Chairman Burns said most of the comments in the go-around thus far were consistent with his own thinking. He would interrupt the discussion at this point to read a news story which had just come over the wire relating to the FHLBB action he had mentioned this morning:

> "The Government moved today to put more money into the housing market in an effort to stabilize interest rates and make more money available for lending. The Federal Home Loan Bank Board announced plans to free $800 million by savings and loan associations to increase the availability of funds for home loan

> lending. It did so by reducing the minimum liquidity requirements, the amount of cash and securities that Federally insured savings and loan associations must keep on hand, from 7-1/2 to 7 per cent. At the same time, the Board's companion corporation, the Federal Home Loan Mortgage Corporation, announced it was putting $300 million into purchase of Government-backed mortgage loans in an effort to subsidize interest rates....In addition, the corporation is increasing its activity in purchasing participations in conventional loans by putting another $700 million into the conventional loan market. The Board said that action will reduce interest rates on conventional loans from 7-7/8 per cent to 7-5/8. Preston Martin, Chairman of the Home Loan Bank Board which regulates the savings and loan industry, said the action is meant as a signal to mortgage lenders that the Board is determined to provide sufficient funds for mortgage lending, thereby reducing upward pressure on interest rates. He said the Board's action 'is in lieu of a freeze on mortgage interest rates.'"

The Chairman said he understood from Mr. Molony that Mr. Martin, when asked at his press conference whether he had consulted with the Federal Reserve, had noted that he had talked with him (Chairman Burns) but had referred the questioner to the Board for information on the content of that conversation. Board personnel were responding to inquiries on the subject with a "no comment." Also, it appeared that a rumor was now circulating in financial markets to the effect that the Board was acting to cut reserve requirements as a cooperative measure.

Mr. Daane said the developments the Chairman had just reported strengthened his view that the Committee should adopt a positive posture in support of the anti-inflationary thrust of

the President's program. He thought it would be important to avoid giving any overt signal of an easier monetary policy, through a reduction in reserve requirements or otherwise. In that context, he thought the Committee could risk a little backup in interest rates.

Mr. Mitchell remarked that he also would not take a neutralist approach to policy. He thought the Committee should respond to the significant developments that had occurred--the change in inflationary expectations, the tendency for interest rates to decline, and the more moderate rates of growth in the monetary aggregates now in prospect. In place of the various alternatives that had been proposed for the second paragraph of the directive he would suggest the following:

> To implement this policy, taking into account the change in inflationary expectations, the Committee seeks to accommodate lower interest rates and more moderate growth in the monetary aggregates likely to ensue from market developments and consumer attitudes in the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with those objectives, provided operations shall be modified if there are significant deviations from these expectations.

He would add only one substantive point, Mr. Mitchell continued. According to the Federal Reserve survey of demand deposit ownership, the rise in M_1 over the past five months had

been largely concentrated in the consumer sector. An analysis of the debits data suggested that there had been no change in the ownership of money in New York during that period and not very much change in the six other major centers; most of the change had occurred in other parts of the country. If consumers accelerated their spending and consequently drew down their money balances, the growth rate of M_1 should diminish. Growth of M_2 also should slow as reintermediation lessened. Under the directive language he had proposed the Manager would be expected to take corrective action if those expectations were not borne out.

Mr. Heflin said he agreed in general with Mr. Daane. In particular, he thought it was important to avoid any action that might contribute to a sharp change in market expectations for interest rates. For the directive he would prefer the language of alternative B and the specifications associated in the blue book with alternative A.

Mr. Clay indicated that he favored the revised language of alternative B that had been proposed by the Chairman and the specifications associated with alternative A, except that he would reduce the lower limit of the range indicated for the Federal funds rate to 5 per cent.

Mr. Mayo said his position was similar to Mr. Clay's. In his judgment it would be desirable to widen the range for the funds rate for reasons that had been advanced in the earlier

discussion of a reserve target. However, while he thought a Federal funds rate as low as 5 per cent would be acceptable if produced by market forces, he would not want to have the Desk actively press for such a rate.

In response to a question by Mr. Daane, Mr. Holmes said that a reduction in the Federal funds rate to 5 per cent might tend to rekindle inflationary expectations, particularly if it occurred at a time when there was no visible evidence that growth in the monetary aggregates was slackening. He should note, however, that prospective developments in the international area were still a matter of conjecture; if they were of a nature that tended to produce a sharp backup in domestic bill rates, and the rise was showing signs of spreading to capital markets, a lower funds rate might have a calming effect.

Mr. Mayo remarked that it seemed desirable to give the Manager the flexibility to permit the funds rate to decline to 5 per cent.

Mr. Hayes suggested that such flexibility should be granted only on the understanding that it would be exercised with great caution.

Mr. MacLaury indicated that he preferred the revised version of alternative B, with specifications between those of alternatives A and B.

Mr. Swan said he favored the revised version of B and the specifications of A, except that he would have no objection to a lower limit of 5 per cent for the Federal funds rate. Indeed, he thought a reduction in the funds rate would be desirable if evidence was publicly available that growth in the monetary aggregates was slowing. On the other hand, he would not want the Desk to attempt to lead the market down.

Mr. Coldwell said he was willing to accept the revised language of alternative B and the specifications of A modified to include a lower limit of 5 per cent for the Federal funds rate. He wondered, however, whether it would not also be desirable to reduce the lower limit of the range indicated for the three-month bill rate. Perhaps the 4-3/4 to 5-1/2 per cent range associated with alternative A in the blue book should be widened to 4-1/2 to 5-1/2 per cent.

Mr. Holmes indicated that it had been the Desk's recent practice to attach much less weight to the bill rate than to the funds rate as a guide to operations, and the market had become accustomed to bill rate fluctuations over a wide range in response to changes in supply and demand. Unless instructed otherwise, he would propose to continue to permit such fluctuations.

Mr. Morris said he preferred the revised language of alternative B and the specifications of alternative A.

Mr. Robertson said he would submit the text of his prepared statement for the record. As indicated therein, his preference for the directive would be either alternative C or D. However, he could also accept the revised version of alternative B. He would like to see more moderate growth in the monetary aggregates and a lower Federal funds rate, and he believed both would result from developments now in process. With respect to the funds rate, he thought the Desk should not resist tendencies for it to decline unless a reduction was likely to create serious problems. At the same time, he would not want the Desk to work actively to lower the funds rate.

Mr. Robertson's prepared statement read as follows:

The new economic program instituted by the Government puts an entirely new cast on the economic outlook. I applaud the steps the President has taken. They can provide the basis for constructive and badly needed reforms. I hope that his Administration will use the purchased time to thrash out new and workable policies to reduce inflation and unemployment and to reestablish a reasonable balance of payments position, an effort toward which we must cooperate to the fullest extent of our ability. But it is not at all clear how successful our efforts will be or how long this troublesome transition period may last. We will therefore have to operate in a highly uncertain environment.

Formulating monetary policy in this climate, with all its uncertainties, is a very troublesome task. Certainly, this is no time to make drastic or doctrinaire changes in the way we conduct our policy. Perhaps the safest course for us to strive for between now and our next meeting is to avoid making any big mistakes, with the expectation that, when the dust settles, we will be better able to refine our aims and procedures.

What does that mean in the way of an operating policy? We must avoid undue attention to movements in interest rates. In this environment, rates can give off more misleading signals than can the movements of monetary aggregates. Apart from short-run technical factors, I see no economic reason now why monetary aggregates should bulge larger than in the past, and I see several reasons to expect more moderate growth in the aggregates; the staff has listed such reasons in the blue book.[1] Therefore, I favor a policy which would look in that direction, and I would not be concerned with how much Federal funds and other short term rates soften so long as aggregates do not bulge.

But I certainly do not want at this time to move to a single aggregate target for the Desk--such as total reserves, for example. We have talked of this subject from time to time in this Committee. As long ago as 1961, I was urging the Committee to pay some attention to aggregates, but I was also emphasizing the need to avoid a single total reserve target in view of its many technical difficulties and conceptual ambiguities.

What I would like to see is the Manager thinking less in terms of specific money market conditions and more of maintaining a climate of bank reserve conditions conducive to the promotion of desired growth in various monetary aggregates. To be as explicit as I

1/ The blue book passage referred to read as follows: "The President's new economic program seems likely to have the effect of reducing rates of growth in the aggregates at given levels of interest rates. First, as the program strengthens confidence in economic and financial prospects, the drop-off we had been anticipating earlier from the apparently very high recent liquidity demands for money should be accentuated. Second, the program should moderate inflationary expectations and reduce the inflation premiums built into current levels of interest rates. Third, our projections indicate that the program will result in slightly smaller increases of nominal GNP over the third and fourth quarters due to an abrupt slowing in the rate of price increase, which implies that the transactions demand for money should also be somewhat lower than otherwise. Finally, insofar as the program is viewed by the market as reducing the need for further firming of monetary policy, expectations of upward pressure on interest rates should be lessened."

can, I would like him to pay first attention to nonborrowed reserves, but also to take account of movements in borrowed reserves and in the market price of reserves, i.e., the Federal funds rate, in planning his operations. I would like to see him move this complex of conditions in more stimulative or restrictive ways according to deviations from the paths specified for M_1, M_2 and the bank credit proxy. I would, though, want him to modify his operations if necessary to forestall extreme fluctuations in money market rates; this is no time to let these move so far so fast as to really upset market attitudes.

I think these purposes would be best served by Committee adoption of either draft directive alternative C or D, as presented by the staff. I prefer the language of alternative D because it seeks to "achieve more moderate growth" rather than "promote moderate growth" of the aggregates. The specifications of alternative D call for slightly more moderation in such growth than alternative C, which itself calls for a significantly slower rate of growth, at least in M_1, than occurred in the spring and summer. However, those specifications for alternative D would contemplate less of a drop in the Federal funds rate than the specifications for alternative C. I find myself wanting both a moderation in the growth rates of the aggregates and a working down of the funds rate. Since I can't guarantee both, my preference would be alternative C but I could accept alternative D--hoping all the while that the changes taking place in the public's desire for money and credit will enable us to achieve both of my objectives under whichever directive we adopt.

Chairman Burns suggested that the Committee vote on a directive consisting of the staff's draft of the first paragraph and the modified version of alternative B for the second paragraph. The modification in B involved replacing the word "promote" with the words "achieve more," so that the first sentence would read

as follows: "To implement this policy, the Committee seeks to achieve more moderate growth in monetary and credit aggregates over the months ahead." It would be understood that the specifications for both the aggregates and money market conditions would be those associated with alternative A in the blue book for the interval before the next meeting of the Committee, except that the lower limit of the range for the Federal funds rate would be reduced from 5-3/8 to 5 per cent. Also, while the Committee had not considered the matter during its discussion, he would propose that the Desk be given a further instruction: if it were found to be desirable to reduce the funds rate significantly in the coming period, such action should not be taken immediately following today's meeting.

No objection was expressed to such an additional instruction.

Mr. Maisel asked whether the staff could indicate the consequences for the expected growth rates in the monetary aggregates of the proposed reduction in the lower limit of the range for the funds rate.

Mr. Axilrod replied that the expected growth rates would be raised toward those associated with alternative B if a 5 per cent funds rate were attained relatively early in the period. The immediate effect would be smaller, of course, if the

reduction occurred gradually over the coming period or was effectuated late in the period.

Mr. Maisel observed that, as he had mentioned earlier, under alternative A an average rate of growth of only 3-1/2 per cent was anticipated for M_1 over the last four months of the year. In his judgment it would be wrong for the Committee to accept so low a growth rate as its target for that period.

Chairman Burns said he would agree that an average rate of 3-1/2 per cent over the next four months would be too low. He noted, however, that that figure was based on a staff projection which he was not prepared to accept as necessarily valid. He planned to vote for the proposed directive because he favored more moderate growth in the aggregates, and he would not interpret his vote as an endorsement of the alternative A growth path for the next four months. However, he thought that growth along that path for a month or two would do no harm.

Mr. Mitchell remarked that he would not object to M_1 growing very slowly even for a month or two if interest rates were behaving in a satisfactory manner.

The Chairman observed that he would be quite pleased if it proved possible to achieve the desired moderation in growth rates along with substantial declines in interest rates.

Mr. Maisel said he assumed that the Desk would act to ease money market conditions if the aggregates were falling significantly short of the expected paths. There was a question, however, of the specific point at which such action would be taken.

Mr. Sherrill observed that the primary instruction in the proposed directive related to the aggregates and not to money market conditions. He noted that he had originally suggested reducing the lower limit of the range for the funds rate in order to provide more latitude for easing actions in the event of a shortfall in the aggregates.

Chairman Burns expressed the view that the proposed directive would be in harmony with the President's new economic program. The Committee would not be pushing for lower interest rates but it would be prepared to accommodate declines, albeit reluctantly during the next week or so.

> By unanimous vote, 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 indicates that real output of goods and services has been expanding moderately, that unemployment has remained substantial, and that prices and wages have been rising rapidly on average in recent months. However, the economic program announced by the President on August 15 enhances prospects for higher rates of growth in real economic activity, increased job opportunities, and curtailed inflationary pressures. In July inflows of consumer-type

time and savings funds slowed markedly at banks, but inflows to nonbank thrift institutions continued large. Growth in the narrowly defined money stock remained rapid in July, but growth in broadly defined money slowed and bank credit continued to expand at about the second-quarter pace. Interest rates on most types of market securities declined sharply in the days following the announcement of the new program. The deficit in the U.S. balance of payments reached extraordinarily large proportions in early August, mainly reflecting an acceleration of capital outflows related to expectations of shifts in foreign exchange rates. Following the suspension of convertibility of the dollar into gold and other reserve assets, major European central banks discontinued foreign exchange market operations for a week. When most of the European markets were reopened on August 23 these central banks pursued diverse exchange rate policies, but all allowed at least some types of market transactions to take place at rates of exchange for their currencies relative to the dollar above previous upper intervention limits. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

To implement this policy, the Committee seeks to achieve more moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective.

Chairman Burns then noted that the Committee had planned to reach a final decision today on the question of authorizing outright operations in the issues of Federal agencies, and that in preparation for the discussion the staff had updated the background

materials on the subject.[1] As the members would recall, the Committee had deferred action on the matter in April, at the request of the Treasury.

The Chairman asked Mr. Holland to report on the Treasury's present view and to describe the circumstances that made action by the Committee desirable at this time.

Mr. Holland observed that, while the Treasury had expressed some reservations about the possible market effects of such operations, their specific reason for suggesting last spring that the matter be deferred was that affirmative action might reduce the chances for enactment of legislation they planned to propose that would permit consolidation of various agency issues into a Federal Financing Bank. Recently, however, when the Treasury had been advised that the Committee would be considering the matter at today's meeting, Under Secretary Volcker had indicated that the Treasury would interpose no objections if the Federal Reserve decided that operations in agency issues were in the economic interest of the country. Some Treasury officials continued to have reservations about how such operations would work out in practice but they felt that was a problem for the System to deal with.

1/ The materials in question, consisting of a memorandum entitled "Outright System Operations in Federal Agency Issues" and a number of appendixes, had been distributed to the Committee on August 6. A copy of these materials has been placed in the Committee's files.

Mr. Holland remarked that a decision by the Committee--whether affirmative or negative--would be desirable at this time to facilitate timely coordination with the transmittal to Congress of the Board's large-scale housing study, now scheduled for around September 15. The staff would suggest that if the Committee decided to amend its continuing authority directive to authorize outright operations in agency issues, it take that action on the understanding that the Chairman would have the authority to determine, after consultation with the Manager, the timing of both the public announcement and the actual implementation of operations.

Mr. Maisel asked whether it was proposed to refer to System operations in agency issues in the housing study.

Chairman Burns said he did not know what recommendation the staff might make on that point. In any case, final decisions on such questions remained to be made by the Board.

Mr. Maisel then asked whether the staff thought that System operations in agencies would be of significant benefit to the national housing program.

Mr. Axilrod replied that in the staff's judgment such operations might be of marginal benefit to housing but probably would not represent a major aid.

The Chairman observed that a number of members of Congress were of the view that System operations in agency issues would be of substantial benefit. They felt that the Committee had demonstrated

an uncooperative attitude in the matter, and they had repeatedly raised the question of why the System had not yet utilized the authority to undertake outright operations granted by legislation five years ago. He would favor affirmative action by the Committee today, since that would be a positive step of some potential value to housing. If the Committee took that action, he thought it would be important not to exaggerate the benefits that were expected to result. The statement might say, for example, that while the Federal Reserve believed that outright operations in agency issues might prove to be of only marginal benefit to housing, it accepted the principle that they would be desirable and was not prepared to discount the potential benefits completely.

Mr. Robertson said that in his judgment the Committee had made a mistake in not acting on this issue long ago. He agreed that operations in agency issues probably would have only a marginal impact on housing finance. As the Chairman had noted, however, a number of members of Congress thought that such operations would have a significant impact. His position was that since the Committee had gone into coupon issues it could just as well operate in agency issues; that would do no harm and could produce some benefits.

Mr. Hayes said that he had been opposed in principle to operations in agency issues and he still thought they might be a mistake. One risk was that a Committee decision to undertake such operations would generate expectations about benefits to housing

that would not be realized. However, he was prepared to defer to the judgment of the Chairman that, on balance, operations in agencies would be desirable. To minimize the risks he would want to adhere closely to guidelines for operations of the kind shown in Appendix B of the staff memorandum.

Mr. Daane remarked that he also had opposed operations in agency issues and still had doubts about their desirability. In addition to the risk Mr. Hayes had mentioned, he was concerned about the technical problems such operations would pose for the Desk, particularly in light of the proliferation of agency issues. However, like Mr. Hayes he was prepared to defer to the Chairman's judgment and vote to authorize operations in agencies.

Mr. Coldwell said he would be willing to undertake such operations on an experimental basis. He had some question about the third of the proposed guidelines which set forth, in terms of a dollar range, the size of the portfolio of agency issues to be acquired in a specified period of time. He thought it would be better to employ some more general statement.

After discussion it was agreed that guideline 3 should be revised to indicate that the System would aim at building up "a modest portfolio of agency issues," without naming any specific amount or time period.

Mr. Heflin said that like others he would be prepared to accept the Chairman's judgment on the question at hand. In

general, however, he thought a distinction should be made between the will of Congress and the wishes of particular Congressmen. The Committee should be responsive to the former but not necessarily to the latter.

The Chairman said he agreed with Mr. Heflin's observation. However, he thought it was fair to say that Congress as a whole was concerned about the housing problem, and that the feeling was widespread in Congress that the System had not been sufficiently sensitive to that problem.

Mr. Mitchell noted that the Committee had discussed the present issue many times in recent years. He proposed that the matter be put to a vote.

Mr. Brimmer said he agreed with Mr. Mitchell. He assumed that the vote would be on the proposed amendment to the continuing authority directive shown as Appendix D of the staff's memorandum. He asked whether--assuming a favorable vote--it was likely that actual operations would be undertaken or an announcement concerning them made before the Board's housing study was submitted to Congress.

Mr. Holland noted that the staff had proposed that the Chairman be given the authority to determine the timing of actual operations and any announcement thereof, after consultation with the Manager.

The Chairman said that one possibility would be to include an announcement of the decision in the Board's forthcoming housing report to Congress. In any case, while actual operations would not be launched immediately they probably would be undertaken relatively soon.

Mr. Eastburn observed that System operations in agency issues would have implications for other sectors as well as for housing. For that reason he wondered whether it would be desirable to include the announcement of the Committee's decision in the housing study. It might be better to make a separate announcement, either before or at about the same time as the housing study was forwarded to Congress.

Several members concurred in Mr. Eastburn's observation.

By unanimous vote, paragraph 1(a) of the continuing authority directive to the Federal Reserve Bank of New York with respect to domestic open market operations was amended to read as follows:

To buy or sell U.S. Government securities and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account at the close of business on the day of a meeting of the Committee at

which action is taken with respect to a current economic policy directive shall not be increased or decreased by more than $2.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting.

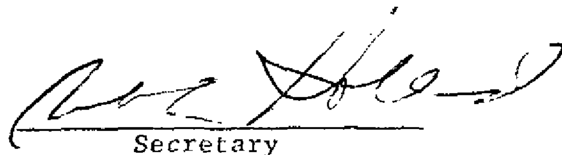
In casting affirmative votes, a number of members indicated that they did so reluctantly.

In connection with the foregoing action, the Committee approved certain guidelines for the conduct of System operations in the securities of Federal agencies.[1/]

Secretary's Note: It was understood that decisions with respect to the implementation of outright operations in agency issues, and the announcement thereof, would be made by Chairman Burns after consultation with the System Account Manager.

It was agreed that the next meeting of the Federal Open Market Committee would be held on Tuesday, September 21, 1971, at 9:30 a.m.

Thereupon the meeting adjourned.



Secretary

1/ The guidelines approved are appended to this memorandum as Attachment B.

ATTACHMENT A

CONFIDENTIAL (FR) August 23, 1971

Drafts of Current Economic Policy Directive for Consideration by the Federal Open Market Committee at its meeting on August 24, 1971

FIRST PARAGRAPH

The information reviewed at this meeting indicates that real output of goods and services has been expanding moderately, that unemployment has remained substantial, and that prices and wages have been rising rapidly on average in recent months. However, the economic program announced by the President on August 15 enhances prospects for higher rates of growth in real economic activity, increased job opportunities, and curtailed inflationary pressures. In July inflows of consumer-type time and savings funds slowed markedly at banks, but inflows to nonbank thrift institutions continued large. Growth in the narrowly defined money stock remained rapid in July, but growth in broadly defined money slowed and bank credit continued to expand at about the second-quarter pace. Interest rates on most types of market securities declined sharply in the days following the announcement of the new program. The deficit in the U.S. balance of payments reached extraordinarily large proportions in early August, mainly reflecting an acceleration of capital outflows related to expectations of shifts in foreign exchange rates. Following the suspension of convertibility of the dollar into gold and other reserve assets, major European central banks discontinued foreign exchange market operations for a week. When most of the European markets were reopened on August 23 these central banks pursued diverse exchange rate policies, but all allowed at least some types of market transactions to take place at rates of exchange for their currencies relative to the dollar above previous upper intervention limits. In light of the foregoing developments, it is the policy of the Federal Open Market Committee to foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

SECOND PARAGRAPH

Alternative A

To implement this policy, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining about the prevailing money market conditions; provided that money market conditions shall be modified if it appears that the monetary and credit aggregates are deviating significantly from the growth paths expected.

Alternative B

To implement this policy, the Committee seeks to promote moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve and money market conditions consistent with that objective.

Alternative C

To implement this policy, the Committee seeks to promote moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve conditions consistent with that objective; provided, however, that operations shall be modified if necessary to avoid excessive fluctuations in money market conditions.

Alternative D

To implement this policy, the Committee seeks to achieve more moderate growth in monetary and credit aggregates over the months ahead. System open market operations until the next meeting of the Committee shall be conducted with a view to achieving bank reserve conditions consistent with that objective; provided, however, that operations shall be modified if necessary to avoid excessive fluctuations in money and short-term credit market conditions.

ATTACHMENT B

GUIDELINES FOR THE CONDUCT OF SYSTEM OPERATIONS IN AGENCY ISSUES

1. System open market operations in Federal agency issues are an integral part of total System open market operations designed to influence bank reserves, money market conditions, and monetary aggregates.

2. System open market operations in Federal agency issues are not designed to support individual sectors of the market or to channel funds into issues of particular agencies.

3. As an initial objective, the System would aim at building up a modest portfolio of agency issues, with the amount and timing dependent on the ability to make net acquisitions without undue market effects.

4. System holdings of maturing agency issues will be allowed to run off at maturity, at least initially.

5. Purchases will be limited to fully taxable issues for which there is an active secondary market. Purchases will also be limited to issues outstanding in amounts of $300 million or over in cases where the obligations have a maturity of five years or less at the time of purchase, and to issues outstanding in amounts of $200 million or over in cases where the securities have a maturity of more than five years at the time of purchase.

6. System holdings of any one issue at any one time will not exceed 10 per cent of the amount of the issue outstanding. There will be no specific limit on aggregate holdings of the issues of any one agency.

7. No new issue will be purchased in the secondary market until at least two weeks after the issue date.

8. All outright purchases, sales and holdings of agency issues will be for the System Open Market Account.